VIEWPOINTS ON PUBLIC FINANCE

A BOOK OF READINGS

EDITED BY

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PREFACE

THESE SELECTIONS from the literature on public finance have been compiled with the objective of providing:

1. supplementary reading for college students of public finance;
2. a text for those who prefer to study the points of high interest in the field as treated by many authors;
3. a presentation of conflicting viewpoints on controversial matters;
4. primary documentary and judicial sources; and
5. time and space perspective in public-finance writing.

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In the laborious task of preparing these materials for publication the editor has had the loyal, diligent, and capable assistance of Helen Hoopes Groves, Mrs. Marion Goetz, and Mrs. Mary Zawacki.

It is hoped that the book may assist some citizens along the arduous highway toward a broad knowledge and an informed opinion in a complicated area of government and economics.

H. M. G.

Madison, Wisconsin
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CHAPTER 1

DISTRIBUTION OF GOVERNMENTAL BURDENS

MODERN governments raise great amounts of revenue and employ a bewildering variety of taxes to this end. Most of these taxes are being constantly criticized on the ground that they are wrong in principle. This suggests the need of establishing certain fundamentals or norms that may serve as standards of good taxation practice. Some have sought to meet this need by developing a list of characteristics that a good tax or tax system should have. Others have looked for a principle of distribution and have usually weighed "benefits received" against "ability to pay." This frequently leads into a discussion of rates and the advisability of taxing the wealthy at a higher ratio to income or wealth than the poor. The nonfiscal purpose of equalizing economic opportunity or rewards can hardly be ignored. To some persons progressive taxation is merely a demagogic attempt to "soak the rich"; to others it is an essential of democratic government. This chapter is a symposium of past and present views concerning these fundamentals.

E.R.A. SELIGMAN

The Social Theory of Fiscal Science

PROFESSOR SELIGMAN here * analyzes the nature of the state and the character of the wants it satisfies. Some wants are satisfied by the individual alone or by him in conjunction with his family. Others are common wants and are satisfied through group organizations and activities.

Thus "a religiously minded individual generally joins the church, so that his religious want is a common want, to be satisfied only by the group. But if he goes into the wilderness, like many a Christian or Buddhist saint, his religious want becomes a separate want, without the necessity of any communion with other mortals. If an individual can kill his own game, his need for food is a separate want; if, as in some of the Australian groups, he can satisfy his hunger only by associating himself with a hunting or fishing pack, his want for food becomes a common want. If he can buy the food from somebody else, the want becomes a reciprocal want."

Many groups require financial sustenance and a plan for distributing dues or charges or contributions among members. Often the contributions are equal. But some organizations, such as churches and philanthropic associations, are supported by collections based mainly on ability to pay. "There is still an equality, but no longer, as before, an absolute equality. The new equality, which reconciles all to a sense of its fitness, is the relative or proportional equality, innate in the idea of faculty or ability.

"It may happen . . . that the individual possesses both common and separate wants. A member of a golf club may none the less enjoy a good cigar. He joins the golf club, indeed, in order to play golf, not in order to smoke a cigar; but he may like to smoke a cigar during or after the game. The club may therefore decide, in addition to its principal function of providing a golf course and a golf house, to assume the subordinate function of furnishing cigars to those members who desire them, even though other members may not smoke, or may not care to smoke at

* Reprinted from *Political Science Quarterly*, XLI (1926), 191–218; 354–383, by permission of The Academy of Political Science, Columbia University, New York.

that time. If the club steward has cigars to dispose of, is there any reason why he should not sell a cigar to the member who wants it, and who is willing to pay for it? In other words, the group, acting through the steward, now enters into relations with its own members on a different basis from the ordinary one. In addition to satisfying the common wants of the members for a golf course, it now satisfies his separate want for a cigar. The group, in other words, in addition to carrying on its primary joint activities, may also carry on secondary, quasi-separate activities. The group members in addition to making common contributions to common ends, may thus make particular contributions to special separate ends. The group member then stands in a double relation to his fellow members and to the group—the ordinary group relation and the exceptional specific or reciprocal relation."

Predominant among the many group organizations is the government. It satisfies the more fundamental of common wants, including, of course, the vital one of protection. Government differs from other organizations in universality, comprising as it does all the members in a community. The state alone exercises compulsion, including the rule that members are not at liberty to join or leave. "There is no place outside the group for the otherwise-minded. . . ." Wants satisfied through government are usually nonreciprocal. "The fundamental nature of common wants completely submerges considerations of the special or separate interests of the individual." The benefits of government accordingly are usually indivisible and immeasurable. An exception occurs in the type of service usually paid for by prices or fees. Professor Seligman concludes his analysis as follows:

Conclusion

The social theory of fiscal science which has been here expounded thus affords a solution of problems which have long vexed the investigator. It supplements the work of the sociologists who have thus far made almost no attempt to apply their theories to economic life. It rounds out the efforts of the economists to trace the social implications of their science.

In the first place it shows us that fiscal science, like economics, is a part of social science in the wider sense. Fiscal science is a social discipline. The root explanation of the fiscal relations of the individual is to be sought in his group membership—not membership in the public group, but membership in the group as such. It is this membership which transmutes and transfigures the individual. Fiscal wants are common wants, and only through analysis of common wants can we reach a solid basis for a consideration of the fiscal activities of the state.

Secondly, the social theory of fiscal science answers the much-mooted question as to what is the proper subject of fiscal science—the state or the individual. It shows, in fact, the ir-

relevance of such a question: for, as we have explained it, the state is nothing but the individuals that compose the state. Only we must be careful to use the terms correctly. The state is indeed not an organism, and still less a superorganism: but the state is much more than the mere collocation of individuals. No individuals as such can ever explain the state, or for that matter, any group, private as well as public. An individual, associated with other individuals in a cooperative group, private or public, becomes at once by the mere fact of association something different from his former self. His special separate wants are transmuted into common wants. He creates the group, but is recreated by the group. Physically he is the same; psychologically and spiritually he is different. His transition from an isolated individual to a group member is of paramount importance. The union of group members is something very distinct from the chance collocation of separate individuals. What is true of all groups is necessarily true of the public group.

It follows, therefore, that when we say that the subject of fiscal science is the state, we mean that the subject of the science consists of the fiscal relations of the members of the state. These fiscal relations are not those of individuals as such, but of individuals in their political or public capacity. It is therefore immaterial whether we say that the public goods discussed in fiscal science deal with public wants and public satisfactions, i.e., the wants and the satisfactions of the state; or whether we say that they deal with the common wants and the common satisfactions of the individuals, in their fiscal, i.e., their public-economic relations with each other. The subject matter of fiscal science is the fiscal relation of the state to its members, that is the mutual fiscal relations of those that constitute the state.

In the third place, the social theory of fiscal science shows that it is a part not only of social science but also of political science. That it is a part of economic science goes without saying. For fiscal science deals with economic values, i.e., with certain aspects of the problem of wealth. Fiscal science, however, is a part of political science in that it deals primarily with the public-group relation, and neither with the private-group nor with the exchange-group relations of the individual that are designed to satisfy either his common or his reciprocal wants. The social theory of fiscal science clarifies the distinction between the private and the public group. What scholars have thus far in vain attempted to achieve—namely a precise statement of the difference between private and public groups, the social theory of fiscal science is able to accomplish. For, as we have learned, it is chiefly through an emphasis on these relations between group income and group outgo that it has become possible to explain the hitherto unrecognized differences between the private and the public groups.

In the fourth place, the social theory of fiscal science has succeeded in showing that in the economics of all group life a place must be found for the subordinate, as well as for the primary, group activities; and that side by side with the normal activities designed so satisfy common wants there are also incidental activities calculated to satisfy the special wants and the reciprocal wants both of the group and of the group mem-

bers. It is only through emphasis on the fiscal relations—that is, the economic relations of group income and group outgo—that we have been led to a consideration of the quasi-single and the quasi-separate activities as over against the common activities of group life in general. It is this analysis which has illumined the dark recesses of the subject, and cleared up what has hitherto been a confused field of speculation.

Finally, the social theory of fiscal science has enabled us to put into their proper places the rival theories that have so long disputed the mastery in public finance. The long-continued contest between the theories of benefit and of ability as the controlling explanation of fiscal relations must be abandoned. We have learned not only that there is no such unitary explanation of fiscal relations, but also that each principle has its appropriate sphere of action. We have learned further that in some respects neither is an independent canon, but that each is under certain conditions affected by the other. Special benefit may be modified by ability; ability may be modified by special benefit. These considerations afford a basis at least for applications, in both theory and practice, which have never yet been made to the detailed content of fiscal science, but which are manifestly out of place here.

Is it too much, then, to hope that the social theory of fiscal science may not only throw some light on sociology itself, but may also prove to be the beginning of a new and fruitful treatment of fiscal science?

2

ADAM SMITH

Canons of Taxation

MANY writers on public finance have sought to reduce the problem of tax distribution to a few general principles or "canons." This practice goes back at least to the work of Adam Smith, whose canons are among the most celebrated passages in the literature of finance: *

The private revenue of individuals, it has been shown in the first book of this Inquiry, arises ultimately from three different sources: Rent, Profit, and Wages. Every tax must finally be paid from some one or other of those three different sorts of revenue, or from all of them indifferently. I shall endeavor to give the best account I can, first, of those

* *Wealth of Nations,* Book V, Chap. 2.

taxes which it is intended should fall upon rent; secondly, of those which it is intended should fall upon profit; thirdly, of those which it is intended should fall upon wages; and fourthly, of those which it is intended should fall indifferently upon all those three different sources of private revenue. The particular consideration of each of these four different sorts of taxes will divide the second part of the present chapter into four articles, three of which will require several other subdivisions. Many of those taxes, it will appear from the following review, are not finally paid from the fund, or source of revenue, upon which it was intended they should fall.

Before I enter upon the examination of particular taxes, it is necessary to premise the four following maxims with regard to taxes in general.

I. The subjects of every state ought to contribute toward the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate. In the observation or neglect of this maxim consists what is called the equality or inequality of taxation. Every tax, it must be observed, once for all, which falls finally upon one only of the three sorts of revenue above mentioned, is necessarily unequal, in so far as it does not affect the other two. In the following examination of different taxes I shall seldom take much further notice of this sort of inequality, but shall, in most cases, confine my observations to that inequality, which is occasioned by a particular tax falling unequally even upon that particular sort of private revenue which is affected by it.

II. The tax which each individual is bound to pay, ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax-gatherer, who can either aggravate the tax upon any obnoxious contributor, or extort, by the terror of such aggravation, some present or perquisite to himself. The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt. The certainty of what each individual ought to pay is, in taxation, a matter of so great importance, that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty.

III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. A tax upon the rent of land or of houses, payable at the same term at which such rents are usually paid, is levied at the time when it is most likely to be convenient for the contributor to pay; or, when he is most likely to have wherewithal to pay. Taxes upon such consumable goods as are articles of luxury, are all finally paid by the consumer, and generally in a manner

that is very convenient for him. He pays them by little and little, as he has occasion to buy the goods. As he is at liberty, too, either to buy or not to buy, as he pleases, it must be his own fault if he ever suffers any considerable inconveniency from such taxes.

IV. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, in the four following ways. First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people. Secondly, it may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds which might enable them more easily to do so. Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have received from the employment of their capitals. An injudicious tax offers a great temptation to smuggling. But the penalties of smuggling must rise in proportion to the temptation. The law, contrary to all the ordinary principles of justice, first creates the temptation, and then punishes those who yield to it; and it commonly enhances the punishment, too, in proportion to the very circumstance which ought certainly to alleviate it, the temptation to commit the crime. Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax-gatherers it may expose them to much unnecessary trouble, vexation, and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it. It is in some one or other of these four different ways that taxes are frequently so much more burdensome to the people than they are beneficial to the sovereign.

The evident justice and utility of the foregoing maxims have recommended them more or less to the attention of all nations. All nations have endeavored, to the best of their judgment, to render their taxes as equal as they could contrive; as certain, as convenient to the contributor, both in the time and in the mode of payment, and, in proportion to the revenue which they brought to the prince, as little burdensome to the people. The following short review of some of the principal taxes which have taken place in different ages and countries will show that the endeavors of all nations have not in this respect been equally successful.

JOHN STUART MILL

The Benefit Principle

IT HAS sometimes been contended that the simple rule of paying for what one gets, as applied in private trade, should be similarly applied to goods and services supplied by the government. This view was criticized by John Stuart Mill as follows:*

For what reason ought equality to be the rule in matters of taxation? For the reason, that it ought to be so in all affairs of government. As a government ought to make no distinction of persons or classes in the strength of their claims on it, whatever sacrifices it requires from them should be made to bear as nearly as possible with the same pressure upon all; which, it must be observed, is the mode by which least sacrifice is occasioned on the whole. If any one bears less than his fair share of the burthen, some other person must suffer more than his share, and the alleviation to the one is not, on the average, so great a good to him as the increased pressure upon the other is an evil. Equality of taxation, therefore, as a maxim of politics, means equality of sacrifice. It means apportioning the contribution of each person toward the expenses of government, so that he shall feel neither more nor less inconvenience from his share of the payment than every other person experiences from his. This standard, like other standards of perfection, cannot be completely realized; but the first object in every practical discussion should be to know what perfection is.

There are persons, however, who are not content with the general principles of justice as a basis to ground a rule of finance upon, but must have something, as they think, more specifically appropriate to the subject. What best pleases them is, to regard the taxes paid by each member of the community as an equivalent for value received, in the shape of service to himself; and they prefer to rest the justice of making each contribute in proportion to his means, upon the ground that he who has twice as much property to be protected, receives, on an accurate calculation, twice as much protection, and ought, on the principles of bargain and sale, to pay twice as much for it. Since, however, the assumption that government exists solely for the protection of property, is not one to be deliberately adhered to; some consistent adherents of the *quid pro quo* principle go on to observe, that pro-

* *Principles of Political Economy,* Book V, Chap. 2, Secs. 2–4. The version here presented is that edited and used by Charles J. Bullock, *Selected Readings in Public Finance,* Third Edition, 1924, pp. 241–244. Reprinted by permission of Ginn and Company, Publishers, Boston, Mass.

tection being required for person as well as property, and everybody's person receiving the same amount of protection, a poll tax of a fixed sum per head is a proper equivalent for this part of the benefits of government; while the remaining part, protection to property, should be paid for in proportion to property. There is in this adjustment a false air of nice adaptation, very acceptable to some minds. But in the first place, it is not admissible that the protection of persons and that of property are the sole purposes of government. The ends of government are as comprehensive as those of the social union. They consist of all the good, and all the immunity from evil, which the existence of government can be made either directly or indirectly to bestow. In the second place, the practice of setting definite values on things essentially indefinite, and making them a ground of practical conclusions, is peculiarly fertile in false views of social questions. It cannot be admitted, that to be protected in the ownership of ten times as much property is to be ten times as much protected. Neither can it be truly said that the protection of £1000 a year costs the state ten times as much as that of £100 a year, rather than twice as much, or exactly as much. The same judges, soldiers, sailors, who protect the one protect the other; and the larger income does not necessarily, though it may sometimes, require even more policemen. Whether the labor and expense of the protection, or the feelings of the protected person, or any other definite thing be made the standard, there is no such proportion as the one supposed, nor any other definable proportion. If we wanted to estimate the degrees of benefit which different persons derive from the protection of government, we should have to consider who would suffer most if that protection were withdrawn: to which question if any answer could be made, it must be, that those would suffer most who were weakest in mind or body, either by nature or by position. Indeed, such persons would almost infallibly be slaves. If there were any justice, therefore, in the theory of justice now under consideration, those who are least capable of helping or defending themselves, being those to whom the protection of government is the most indispensable, ought to pay the greatest share of its price: the reverse of the true idea of distributive justice, which consists not in imitating but in redressing the inequalities and wrongs of nature.

Government must be regarded as so preeminently a concern of all, that to determine who are most interested in it is of no real importance. If a person or class of persons receive so small a share of the benefit as makes it necessary to raise the question, there is something else than taxation which is amiss, and the thing to be done is to remedy the defect, instead of recognizing it and making it a ground for demanding less taxes. As, in a case of voluntary subscription for a purpose in which all are interested, all are thought to have done their part fairly when each has contributed according to his means, that is, has made an equal sacrifice for the common object; in like manner should this be the principle of compulsory contributions: and it is superfluous to look for a more ingenious or recondite ground to rest the principle upon.

4

HUGH DALTON

Sacrifice Theories

THE VIEW that taxes should be distributed according to ability to pay has a wide following. Closely related is the view that taxes should be progressive. Hugh Dalton has analyzed ability to pay in terms of sacrifice and translated the result into terms of progression of rates. He says: *

The principle that taxation should be distributed between individuals in accordance with their "ability to pay" is, on the face of it, somewhat more practicable. But how is "ability to pay" to be measured? It is usual, in discussions of this question, to consider the "sacrifice" to the taxpayer of paying his taxes, and then to deduce some scheme of distribution of the burden of taxation from some principle concerning sacrifice. The three most common of such principles are those of "equal sacrifice," "proportional sacrifice" and "minimum sacrifice." To these we may add a fourth, which is sometimes expressed by the injunction, "leave them as you find them," or, more precisely, "do not alter the distribution of income by taxation." It is not clear, on grounds of equity, which of these four is to be preferred.

According to the principle of equal sacrifice, the direct money burden of taxation should be so distributed, that the direct real burden on all taxpayers is equal; according to the principle of proportional sacrifice, so that the direct real burden on every taxpayer is proportionate to the economic welfare, which he derives from his income; according to the principle of minimum sacrifice, already referred to, so that the total direct real burden on the taxpayers as a whole is as small as possible; according to the principle of "leave them as you find them," so that the inequality of incomes should be neither increased nor diminished by taxation.

In order to apply any of these four principles, it is necessary to assume some relation between money income and the economic welfare derived from it. According to the relation assumed, there will result a tax system which may be either proportional, progressive or regressive. Under proportional taxation all taxpayers contribute the same proportion of their incomes; under progressive taxation, the larger a taxpayer's income, the larger the proportion which he contributes; under regressive taxation, the larger a taxpayer's income,

* *Principles of Public Finance*, 1923. Reprinted by special permission of George Routledge & Sons, Ltd., London, England.

the smaller the proportion which he contributes.[1] These terms may be applied, not only to tax systems as a whole, but also to particular taxes. Thus a tax system that is proportional as a whole may contain some taxes that are progressive and others that are regressive, and a tax system that is progressive as a whole may contain some taxes that are regressive, and conversely. Again, a particular tax system may be proportional over a certain range of incomes, progressive over another range and regressive over yet another range, while there are, of course, an infinite number of possible degrees both of progression and regression.

Assuming that the relation between income and economic welfare is the same for all taxpayers and that the marginal utility of income diminishes fairly rapidly as income increases, the principle of equal sacrifice leads to progressive taxation, the principle of proportional sacrifice to still steeper progressive taxation, and the principle of minimum sacrifice, as already pointed out, to a relatively high level of exemption and very steeply progressive taxation of those not exempt. The principle of minimum sacrifice, indeed, gives this result, so long as it is assumed that marginal utility diminishes at all with increasing income. Both equal sacrifice and proportional sacrifice, rigidly applied, involve making all members of the community, however poor (provided that they have *some* economic welfare to sacrifice) contribute something. But minimum sacrifice does not involve this. Further, the more rapidly the marginal utility of income is assumed to diminish with increasing income, the more steeply progressive must the tax system become, in order to give effect to either equal or proportional sacrifice.

Proportional taxation can only be justified, according to the principle of equal sacrifice, on the assumption that the marginal utility of income diminishes very slowly, and can only be justified, according to the principle of proportional sacrifice, on the assumption that the marginal utility of income does not diminish at all, but remains constant, as income increases. On this last assumption, the principle of minimum sacrifice would lead to no one distribution of taxation more than any other, since the total sacrifice would in all cases be proportionate to the total revenue raised by taxation.

Regressive taxation can only be justified, according to the principle of equal sacrifice, on the assumption that the marginal utility of income diminishes even more slowly than was required in order to justify proportional taxation according to the same principle, or on the assumption that marginal utility does not diminish at all, but remains constant or actually increases. Again, regressive taxation can only be justified according to the principle of proportional sacrifice, on the assumption that marginal utility actually increases and, on this absurd assumption, the principle of minimum sacrifice would lead to exempting from taxation all incomes greater than a certain amount, and taxing all incomes less

[1] Another and rather superfluous term sometimes used in these discussions is degressive taxation, which means that all incomes less than a certain amount are exempt from taxation, and that all incomes greater than this amount are taxed proportionally on the surplus. For the latter class of incomes, therefore, degression is a particular case of progression.

than this amount a hundred per cent.

The fourth principle referred to above, that the inequality of incomes should be neither increased nor diminished by taxation, can only be applied when it has been decided how the inequality of incomes should be measured. It is commonly supposed by its adherents to lead to proportional taxation. But there are strong grounds for holding that, on reasonable assumptions as to the relation of income to economic welfare, this principle also leads to progressive taxation.[2]

It, therefore, appears that, on reasonable assumptions, each of our four alternative interpretations of "ability to pay" leads to some degree of progression in the tax system. This practical conclusion is now generally accepted by modern opinion, which responds readily to the suggestion that considerably the heaviest burdens should be placed upon the broadest backs. But some high authorities still cling with a curious fondness to the idea of proportional taxation. It is true that they have the support, for what it is worth in this connection, of Adam Smith, who held that "the subjects of every state ought to contribute towards the support of the government, as nearly as possible, according to their respective abilities, that is to say in proportion to the revenue, which they respectively enjoy under the protection of the State." But Adam Smith, though a great economist in his day, wrote nearly a hundred and fifty years ago, and before the discovery of the law of diminishing marginal utility.

It is important to notice that the four principles considered above, in common with all principles of equity in taxation, including the austere principle that "everyone ought to pay something," are only matters of opinion. Failing a clearer and more generally accepted definition of equity than has hitherto been forthcoming, it cannot be proved that they are, in fact, equitable, but only that certain people at certain times think them so. And it is a fact of common observation that opinion on such questions is very liable to change. It has been truly said that current ideas of equity generally amount to little more than "economy tempered by conservatism." Equity often seems to say "No," but hardly ever "Yes," an elusive mistress, whom perhaps it is only worth the while of philosophers to pursue ardently and of politicians to watch warily.

If, however, we look at the problem of the distribution of the burden of taxation from the point of view, not of equity, but of economy, we stand on surer ground, though we may ultimately be led to conclusions less simple in form than those furnished by equity. It has been argued in Chapter II of this book that any system of public finance should be conceived simply with a view to the maximum social advantage in the long run, and it follows that any tax system, as part of this larger system, should be conceived with the same object. But it is a necessary preliminary to the consideration of any tax system from this point of view to consider broadly the economic effects of taxation.

[2] See my article on "The Measurement of the Inequality of Incomes," *Economic Journal*, September 1920.

M. SLADE KENDRICK

The Ability to Pay

THE ABILITY-TO-PAY principle is sharply criticized by Professor M. Slade Kendrick, who concludes that progressive taxation should be defended only in terms of its economic effects. His criticism of ability to pay, in part, is stated as follows: *

The sacrifice attached to the payment of taxes is, however, in Professor Seligman's view, to be modified by the relative ease with which the dollars surrendered were obtained. "A man's ability to pay taxes is to be measured not only by the relative burden imposed upon him in parting with his wealth, but also by the relative ease with which he has acquired his wealth." [1] Both the basic premise of sacrifice and the Seligman variant will now be examined.

The idea of sacrifice when linked to the concept of the declining marginal utility of money has given rise to three theories of progressive taxation: the equal, equal-proportional, and least-sacrifice theories. According to the equal-sacrifice theory, taxes should be laid in such a manner that the sacrifices of all taxpayers are equal. The theory of equal-proportional sacrifice holds that the sacrifice of taxpayers should bear an equal proportion to their incomes. Thus in this view equality of sacrifice is not sufficient. The rich man's tax payment should represent a greater sacrifice than the contribution of a man of moderate means. It should, however, not be greater in relation to his income. The equality is, therefore, to be found in the proportion, not in the quantity of sacrifice.

The theories of equal and of equal-proportional sacrifice both involve the taxation of poor as well as rich persons. In neither theory is there an attempt to make any income group bear all the taxes. The problem for both theories is the distribution of the tax burden among individuals possessed of varying incomes. These theories of taxation may, accordingly, be classified as individual theories. The least-sacrifice theory, on the other hand, is a group theory of taxation. Least sacrifice is interpreted in the group sense. The objective of taxation is least sacrifice to the group. According to this theory, taxes should be laid first on the incomes of the very rich. When these incomes are reduced to the level of the rich, then the rich would be taxed. Persons of moderate means

[1] E. R. A. Seligman, *Studies in Public Finance* (New York: The Macmillan Company, 1925), p. 188.

* "The Ability-To-Pay Theory of Taxation," *American Economic Review*, XXIX, No. 1, Part I (March, 1939), 92–101. Reprinted by permission of the American Economic Association, Evanston, Ill.

would be taxed only after the incomes of the very rich and the rich have been reduced by taxation to their level. The theory calls for the progressive elimination of the high incomes by taxation. In order to obtain the levelling effect sought, the rates of graduation imposed would be extremely steep in the upper ranges.

All three theories, however much they may vary from one another, have a common rootage in the principle that the marginal utility of money declines with an increase in its supply. But, as Professor Pigou has shown, the utility of money must fall more sharply than the theory of declining utility requires if the objective of equal sacrifice leads to progressive taxation. On the contrary, any degree of decline in the utility of money with an increase in the supply would give a basis for progressive taxation under either the theory of equal-proportional sacrifice or that of least sacrifice. Professor Pigou's analysis of the general opinion respecting the relationship between the theory of marginal utility and progressive taxation is so effectively presented that it is quoted here: [2]

> This opinion is to the effect that, in all circumstances, in order to secure equal sacrifice, the tax formula must be in some measure *progressive,* in the sense that the rate of taxation per £ of income grows as incomes grow. This proposition is supposed to be logically deductible from the law of diminishing utility. That supposition is incorrect. All that the law of diminishing utility asserts is that the last £ of a £1,000 income carries less satisfaction than the last £ of a £100 income does. From this doctrine it can be inferred that, in order to secure *equal proportionate sacrifice,*[a] taxation must be progressive, but not that it must be progressive in order to secure *equal* sacrifice. In order to prove that the principle of equal sacrifice necessarily involves progression we should need to know that the last £10 of a £1,000 income carry less satisfaction than the last £1 of a £100 income; and this the law of diminishing utility does not assert.

The concept of marginal utility was developed in economic theory for the purpose of explaining the demand for goods (including services). It is of material assistance in accounting for the fact that an increase in the supply of goods offered results in their sale at lower prices. The curve of the money demand for goods slopes downward to the right. Increasing supplies can be sold only at lower prices. The uncovering of lower strata of purchasing power is not sufficient in itself to account for this economic fact. Recourse must be had also to the decline in utility that comes as additional units are supplied. With a fall in price the poor buy, but the well-to-do who would purchase some units at a higher price buy more at the lower price. When automobiles sell at $1,500, few have two cars. But as the price of an automobile falls to $1,000, the number of families with two cars increases.

The marginal-utility concept when applied to taxation must be extended from the specific commodities for which it is used in economic theory to the generalized commodity, money. For the purposes of gradu-

[2] A. C. Pigou, *A Study in Public Finance* (London: Macmillan & Company, Ltd., 1928), p. 106.

[a] It is easy to see that proportionate taxation could only yield equal proportionate sacrifice if the curve whose ordinates represent the quantities of utility derived by the representative man from successive units of income were a horizontal straight line—a condition incompatible with the law of diminishing utility.

ated taxation, it will not do to say merely that the utility of food, clothing, and other goods declines as their supply increases. The tax is laid not on these things but on money income or inheritance. The utility of money itself, that which has command over all things of purchase and sale whether for near or distant uses, for consumption or investment, and which, in consequence, has come to be the substance of power, the symbol of success, must be held to decline with an increase in supply. The application of the marginal utility concept to a sacrifice theory of taxation requires also that the payment of money by the individual to the government shall be deemed a sacrifice on his part. And, if any of these sacrifice theories is to mean anything in practice, the sacrifices involved in the payment of taxes must be capable of quantitative expression. All these requirements are basic to the doctrines of sacrifice. Thereby they ultimately support the theory of ability to pay as a justification of graduated taxation. Let us examine them.

The relation of the utility of money to the supply possessed by an individual is most difficult to write about. It is easy to believe that the desire for food, even for costly dainties, slackens rapidly as the supply grows from the stage of plenty into that of abundance. Nor is it difficult to think of an individual as having so much clothing, so many automobiles, servants, houses, yachts that the addition of a suit, a car, a maid, a town house, or a cruiser would make little difference to him. Each direction of outlay returns less satisfaction per dollar for the amount expended. There can be too much of any one thing. But can there be too much of *all* things? That is the problem. If the total of things that money buys were composed of goods and services only—clothing, furniture, paintings, houses, servants, operas, theatrical performances—the problem would be difficult but perhaps not impossible of solution. Somewhere physiological considerations would limit the satisfaction received from these things. But, as incomes grow larger, goods and services bought for consumption become relatively less important in the total. This is true even of the things of show—the costume balls, racing stables, trips to Newport and Deauville with their rotogravure outcomes, the yachts long of keel and broad of beam—that certify so tangibly the possession of great wealth. Stocks, bonds, mortgages, investments of all kinds, on the other hand, grow relatively greater in significance, and as income is received from them, not all this return is spent for goods and services, so still more money is available for investment. With increased holdings and growing wealth, there come directorships and chairmanships in important corporations, and the valuable perquisite of "inside information" for further gains; honorary degrees from aspiring colleges and universities; memberships in exclusive clubs; the respect of the successful, the envy and admiration of the striving; the notice of everyone, headlines and pictures in the press; power to better or to worsen the lives of thousands of working men, endow colleges, fill party campaign chests, provide art gallaries, stimulate research; and perhaps ultimately the enjoyment of political preferment.

Does income of this kind decline in satisfaction as more is received? Are power and prestige subject to the same principle as food and furni-

ture? They may, for aught that we know, respond to the opposite principle. Suppose, for example, that an ambassadorship is wanted but that a fortune of 5 million dollars must be had before the required political prominence can be reached, and the necessary expenses of maintaining an ambassadorial establishment can be met. In that instance, once the goal appears in striking distance, the growth of the fortune needed for its attainment is clearly attended by increasing utility. Men being as they are, who can deny that power and prestige may whet but never satiate the appetite?

The second requirement for a sacrifice theory of taxation is that the payment of taxes shall be a sacrifice to the payer. At first thought, it might seem that this requirement could be passed over without discussion. The payment of taxes is ordinarily not a cause for rejoicing. The taxpayer feels the loss, and may strive by one means or other to avoid it. If, however, we ask whether the payment of taxes is, in reality, a sacrifice, we are on different ground. The collection from the taxpayer finances many governmental services that he would be unwilling to do without, and for which he would be glad to pay if they could not be had on other terms.[3] We do not consider payment for groceries, gasoline, or other commodities to be a sacrifice. Such payments are mere exchanges. Dollars are surrendered, satisfactions are received. Sacrifice does not enter into the matter at all. Why then, should the payment of taxes that finance needed services of government be called a sacrifice? The fact that there is no direct *quid pro quo*, as in trade, may account for the feeling of deprivation that the taxpayer experiences. This feeling is, however, not conclusive in respect to the question of sacrifice. The services of government would, it is true, be accepted preferably without the payment of taxes. But groceries, automobiles, and other good things of life would also be received gladly on the same terms. It would indeed be a glorious world if things could be had without cost.[4]

Still another aspect of the difficulty with the concept of sacrifice, effective throughout progressive income and inheritance taxation, appears at its clearest with respect to the upper ranges of the graduation. We have already observed the nature of large incomes, the fact that they are spent only in small part for the material necessaries and even luxuries of life, and are significant mostly for the power and prestige that go with the possession of great wealth and its accumulation. Suppose now a progressive tax to be laid, which imposes a heavy obligation on large incomes. Is the payment of such a tax to be accounted a sacrifice to these rich possessors? Their current expenditures for consumption are disturbed little if at all. They still eat choice foods, drink rare wines, ride in expensive automobiles, and maintain cruisers or yachts. True, the automobile may have less custom work, and the yacht may be shorter of keel, narrower of

[3] This is not an intermixture of benefit theory. One may be glad that a given governmental service is provided and be willing to pay for it without being able to evaluate the worth of this service to him personally.

[4] The point—brought out later—that individuals differ in their attitudes, feelings, responses is also not properly to be urged in support of the position that the payment of taxes is a sacrifice. On balance, these differences might be held, by the same logic, to indicate that the payment of taxes is a benefit.

beam, and contain cabins less gorgeous with gilt and murals. The chief deprivation that these rich folk suffer must, therefore, be in relation to their investments. Not so much money is available for investment. Thus, whether the avenue of expenditure be consumption or investment, less money is available for the things of power and prestige. But power and prestige are relative concepts. They are to be had only on the condition that others do not possess them. The peaks stand out only because they are above the mass of the range. Attainment of power and prestige, those human peaks, is the objective of an intense competition in which the rich win as against the poor, the very rich as against the rich, and the richest as against all others. In such a struggle, each contestant would feel the loss of his place seriously. But the tax is not selective in its application. It is laid on all alike within each income group. No one, therefore, is handicapped in the competition. Each is as well off as before in comparison with others in the same group. As among the groups, the richest decline somewhat in relation to the very rich, and the very rich in relation to the rich. But this tendency toward the telescoping of income groups, brought about by the levy of progressive taxation, has small significance in relation to sacrifice. The very rich are still richer than the rich, and the rich continue to have more than the well-to-do.

All this is not put forth as a denial of the existence of sacrifice in taxation. A person who is over-taxed in relation to others of the same status bears a sacrifice. The very poor who pay a general sales tax on the necessaries of their existence clearly sacrifice to make this payment. A whole community may bear a sacrifice in that the people pay taxes and yet do not receive in return governmental services of equivalent worth. The argument here is not directed to these instances of sacrifice but rather to the sacrifice concept in its various interpretations as a justification for the levy of personal income and inheritance taxes at graduated rates.

In order to examine the third requirement for the sacrifice theory of progressive taxation, we shall have to accept the first two for purposes of this inquiry. This last requirement is that the sacrifices arising from the payment of taxes shall be capable of quantitative expression.[5] Perhaps this requirement should be explained with reference to the various sacrifice theories. The theory that the sacrifices of all taxpayers should be equal conveys within itself the idea of quantitative expression. The sacrifices cannot be equal, save as quantities. My sacrifice cannot be equal to yours, in any other than a quantity sense.

The theory of least sacrifice real-

[5] Ample support for this requirement is to be found in the literature of taxation. Gerhard Colm, in "The Ideal Tax System," *Social Research,* August, 1934 (New School for Social Research, New York), states (p. 326):

"The principle of taxation corresponding to the social-liberal ideology is that of ability, of equal, proportionate, or minimum sacrifice. The idea is that taxes should be so assessed as not to disturb the stratification of incomes measured, however, not in money but in some utility unit."

H. G. Brown in *The Economics of Taxation* (Holt, 1924) points out (p. 199) that the concept of equal sacrifice means "to impose an 'equal' amount of 'sacrifice' on all taxpayers."

Essentially the same idea made with respect to the theory of least sacrifice is to be found in Pigou, *A Study in Public Finance,* p. 75.

izes its end by progressive reduction of the larger incomes. The quantity of sacrifice by this method of subtraction is found to be less than that following from the taxation of all incomes. In order to obtain such a result, the sacrifices of the relatively few at the upper end of the scale must be totalled for comparison with the sum of sacrifices that would be suffered by the taxation of all incomes. In no other way is it possible to know which method will yield the least sacrifice. An individual may know that one pain is greater than another, though, as Sir Josiah Stamp remarks, "it is very difficult for a man to say quantitatively that one boot pinches three times as much as the other." [6] But where different persons are concerned, as in the instance of equal sacrifice, it cannot be said that one group bears less sacrifice than the other except by a comparison of the quantities of sacrifice borne by each.

The theory of equal proportional sacrifice seems, on its face, not to involve a quantitative expression of sacrifice. In this view, the test for distribution of the tax burden is the proportion. It would appear then that the sacrifices of taxpayers might be proportionately equal without being quantitatively equal. And so they might, if there were as many tax rates as individuals. In that event—given the necessary degree of insight—the tax payments might be adjusted so that the sacrifice borne by each individual would be in a given proportion to his income, and the *quantity* of sacrifice would nowhere come into consideration, only the proportion.

But, even if the needed information on sacrifice were available, taxes could not be laid on an individual basis. There could not be the thousands or perhaps millions of rate combinations that would be required if each individual's payment were made to represent proportionately the same sacrifice that every other individual's payment would represent. At most, even with full use of the device of graduation, relatively few rates can be levied, and these must be imposed in relation to size of income, source, or other large general considerations.

What does it mean then, in practice, to lay a tax according to the principle of equal proportionate sacrifice? Simply this—if the principle is to be followed—all persons within each income classification must bear the same quantity of sacrifice. Otherwise, the equality of the proportion would fail of realization. Thus if A and B each have a taxable income of $100,000, to which the same schedule of graduated rates is applied, their sacrifices must be quantitatively equal in order that they may be proportionately equal. Furthermore, as among income groups, the quantity of sacrifice borne by each must be computed in order that the graduation shall impose a proportionately equal burden on all the groups. Taxation, according to the principle of equal proportionate sacrifice, cannot, in practice, escape the quantitative determination and comparison of sacrifices. In that respect, it is linked to the other theories. All three theories of taxation according to sacrifice rest, therefore, on the same basis—the quantitative expression of sacrifices.

We have been at some pains to examine the foundation for the sacrifice theory of progressive taxation. It is only by so doing that one can get

[6] Josiah Stamp, *The Principles of Taxation* (London: Macmillan & Company, Ltd., 1921), pp. 53–54.

behind the screen of impressions that the sacrifice concept interposes and examine the reality. The verdict on the sacrifice theory, however interpreted, is clear. Reasons for doubting two of the three essentials on which this theory is founded have already been given. The third fares no better. The reason for this finding is simple. Individuals differ in their complement of feelings, attitudes, responses. No two of us are alike—identical twins excepted. Sacrifices are relative to the individuals that experience them. They are, therefore, not possible of expression in quantitative units of the impersonal sort needed if the sacrifices of persons or groups of persons are to be compared.

If we examine Professor Seligman's variant that ability to pay is an amalgam composed of the sacrifice of paying taxes and the ease with which the money was obtained, the same results are obtained. The points made respecting application of the principle of declining marginal utility to money, and the existence of sacrifice in progressive taxation hold for this view also. And the ease of obtaining money is clearly as much an individual matter as the sacrifice of parting with it. My ease and your ease cannot, therefore, be reduced to comparable units more than our respective sacrifices can. Sacrifice whether pure or an amalgam is not possible of reduction to quantitative expression.

6

E.R.A. SELIGMAN

In Defense of Progressive Taxation

WHAT might be called the standard defense of progressive taxation was classically stated by Professor E. R. A. Seligman as follows: *

President Walker's definition of faculty is well known.[1] Faculty, says he, is "the native or acquired power of production." But if we analyze faculty more closely, in the sense in which we instinctively use the word in tax matters, we see that it means something more than that. It not only implies native or acquired power of production, but includes at least also the opportunity of putting these powers to use, the manner in which the powers are actually employed and the results of their use as

[1] F. A. Walker, "The Bases of Taxation," *Political Science Quarterly,* III (1888), 14.

* *Progressive Taxation in Theory and Practice* (American Economic Association, 1894), pp. 190–195.

measured by periodical or permanent accretion to the producer's possessions. We have seen how the original idea was that represented by President Walker, but how this was soon supplanted by the more real and practicable tests, first of property (or permanent accretion), then of income (or periodical accretion). But, furthermore, faculty connotes an additional conception. It means not only powers of production or results of powers of production, but also the capacity to make use of these powers or these results—the capacity in other words of enjoying the results of the exertions. It is this latter conception which has been developed by recent writers, although they have carried it to an extreme just as one-sided as that represented by the advocates of the earlier theories. The elements of faculty, then, are twofold—those connected with acquisition or production, and those connected with outlay or consumption. What is the application to the matter in hand?

If we regard only the first set of elements, it is evident that the possession of large fortunes or large incomes in itself affords the possessor a decided advantage in augmenting his possessions. The facility of increasing production often grows in more than arithmetical proportion. A rich man may be said to be subject in some sense to the law of increasing returns. The more he has, the easier it is for him to acquire still more. The initial disadvantages have been overcome. This was pointed out already by Adam Smith when he said: "A great stock, though with small profits, generally increases faster than a small stock with great profits. Money, says the proverb, makes money. When you have got a little, it is often easy to get more. The great difficulty is to get that little."[2] While the native power of production remains as before, this "acquired power" has greatly augmented. Hence, from this point of view faculty may be said to increase faster than fortune or income. And this element of taxable capacity would not illogically result in a more than proportional rate of taxation.

On the other hand, the elements of faculty which are connected with outlay or consumption, bring us right back again to the sacrifice theory. While the idea of faculty includes that of sacrifice, the two ideas are not coextensive. Faculty is the larger, sacrifice the smaller conception. Faculty includes two sets of considerations, sacrifice only one. Now, while the sacrifice theory in itself, as we have seen, is not sufficient to make us demand any fixed scale of progression, its influence in the other direction is certainly not strong enough to countervail the productive elements of faculty, which seem to imply progressive taxation. In fact, we may go further and say that the sacrifice theory, or consumption element in faculty, can certainly not be used as an argument necessarily leading to proportional taxation. If it does not lead necessarily to any definite scale of progression, much less can it lead necessarily to a fixed proportional taxation. But if we never can reach an ideal, there is no good reason why we should not strive to get as close to it as possible. Equality of sacrifice, indeed, we can never attain absolutely or exactly, because of the diversity of individual wants and desires; but it is nevertheless most probable that in the majority of normal and typical cases, we shall be get-

[2] *Wealth of Nations*, Book I, Chap. 9.

ting closer to the desired equality by some departure from proportional taxation. In certain individual cases even regressive taxation might accomplish the result best, in other individual cases proportional taxation would be the most serviceable. But if we take a general view, and treat of the average man—and the state can deal only with classes, that is, with average men—it seems probable that on the whole less injustice will be done by adopting some form of progression than by accepting universal rule of proportion. A strictly proportional rate will make no allowance for the exemption of the minimum of subsistence. It will be a heavier burden on the typical average poor man than on the typical average rich man. It will be apt to be relatively more severely felt by the average man who has only a small surplus above socially necessary expenses, than by the average man who has a proportionally larger surplus. It will in short be apt in normal cases to disproportionately curtail the enjoyments of different social classes.

Hence, if we base our doctrine of the equities of taxation on the theory of faculty, both the production and the consumption sides of the theory seem to point to progressive taxation as at all events neither more illogical nor more unjust than proportional taxation. It may, indeed, frankly be conceded that the theory of faculty cannot point out any definite rate of progression as the ideally just rate. In so far there seems to be some truth in Mill's contention that progressive taxation cannot give that "degree of certainty" on which a legislator should act; as well as in McCulloch's assertion that when we abandon proportion we "are at sea without rudder or compass." It is true that proportion is in one sense certain, and progression is uncertain. But their argument proves too much. An uncertain rate, if it be in the general direction of justice, may nevertheless be preferable to a rate which, like that of proportion, may be more certain without being so equitable. Half a loaf is better than no bread. Stability is assuredly a good thing. But it is highly questionable whether a stability which is necessarily unjust is preferable to an instability that works in the general direction of what is recognized as justice. All governmental actions which have to do with money relations of classes are necessarily more or less arbitrary. The fines imposed by the courts, the fixing of the rates of import duties or excise taxes are always, to a certain extent, inexact. And in truth, a strict proportional tax, if we accept the point of view mentioned above, is really more arbitrary as over against the individual taxpayers, than a moderately progressive tax. The ostensible "certainty" involves a really greater arbitrariness.

So, also, the other arguments often advanced against progression seem to be in some measure destitute of foundation.[3] The common objection that progression is confiscation because it must finally end by swallowing up the whole capital may be completely obviated, as we have seen, by making the rate of progression itself degressive; so that it would become impossible to reach one hundred per cent or any like percentage of large fortunes.

The objection that it is a fine put on industry and saving is really not

[3] The objections commonly urged are well summed up in C. F. Bastable, *Public Finance* (3d ed., New York: The Macmillan Company, 1927) pp. 308–313.

applicable to progressive taxation as such, but rather to the whole system of taxation on property or income. The logical conclusion from this would be the demand for taxation only on expense; and even that would be to a certain extent a tax on industry. But it is hard to see why industry and saving should not be taxed, if it increases our capacity to pay taxes; and it is still harder to see how we can avoid taxing industry. Furthermore, it is a mistake to assume that larger fortunes are always the result of individual saving. The argument, in short, is not an argument against progression, but against taxation in general. If a moderately progressive tax is really more equitable than a strictly proportional tax, progression will be less of a fine on thrift and industry than proportion would be.

Finally, the argument that progressive taxes are not productive of revenue is not of great weight. The contention has never been urged that progressive taxes yield less than proportional taxes, but simply that they do not yield more. Now, as it has already been pointed out in a previous chapter, the function of progressive taxation is not so much to obtain increased revenues as to apportion the burden more equally among the taxpayers. If it is conceded that the progressive tax is more equitable than the proportional tax it is utterly immaterial whether it yields more revenue or not.

7

JOHN R. McCULLOCH

For Proportional Taxation

A CLASSIC statement of the case for proportional taxation was made by John R. McCulloch during the middle of the nineteenth century as follows: *

There can be no doubt that, were it practicable, the burden of taxation should be made to press on individuals in proportion to their respective revenues. A, with an income of £1000 a year, ought to pay ten times the tax paid by B, who has only £100 a year, and the latter ten times as much as C, who has only a pittance of £10.[1] The state has been ingeniously compared by M. Thiers to a

[1] It is, perhaps, needless to say that the incomes of the different parties are supposed to be perpetual, or of the same duration.

* *A Treatise on the Principles and Practical Influence of Taxation and the Funding System* (2d ed.; 1865), pp. 17–21; 139–141. The version here presented is that edited and used by Charles J. Bullock, *Selected Readings in Public Finance,* Third Edition, 1924, pp. 236–241. Reprinted by permission of Ginn and Company, Publishers, Boston, Mass.

mutual insurance company, where the payments by the members are exactly proportioned to the sums they have insured, or to their interests in the company. And so it should be with the subjects of government. It is established for the common benefit of all—of those who labor with the hand, and of those who labor with the head; of those to whom property has descended, and of those by whom it has been acquired; and is alike indispensable to their well-being and prosperity. And being so, it necessarily follows that every individual should contribute to its support according to his stake in the society, or to his means. This is a plain as well as a sound rule; and it is one that should never be forgotten or overlooked.

Practically, however, it is not possible to attain to anything like a perfect equality of taxation; and provided no tax be imposed in the view of trenching on this principle, or of making one class or order of people pay more in proportion to their means than others, the equality of taxation is of less importance. In this, as in most other departments of politics, we have only a choice of difficulties; and what is absolutely right must often give way to what is expedient and practicable. It is the business of the legislator to look at the practical influence of different taxes, and to resort in preference to those by which the revenue may be raised with the smallest inconvenience. Should the taxes least adverse to the public interests fall on the contributors according to their respective abilities, it will be an additional recommendation in their favor. But the *salus populi* is in this, as it should be in every similar matter, the prime consideration; and the tax which is best fitted to promote, or least opposed to, this great end, though it may not press quite equally on the different orders of society, is to be preferred to a more equal but otherwise less advantageous tax. Were Smith's first maxim restricted to taxes laid directly on property or income, it would be quite as true in a practical as in a theoretical point of view. Equality is of the essence of such taxes; and whenever they cease to be equal, they become partial and unjust. But in laying down a practical rule that is to apply to all taxes, equality of contribution is an inferior consideration. The distinguishing characteristic of the best tax is, not that it is most nearly proportioned to the means of individuals, but that it is easily assessed and collected, and is, at the same time, most conducive, all things considered, to the public interests.

The truth is, that the greater number of taxes, including, we believe, every one that is least injurious, are imposed without any regard to the equality of their pressure. They consist of duties payable by those who use certain articles or exercise certain privileges, and by those only. Taxes of this sort, though not proportioned to the abilities of the consumers, are neither partial nor unfair; and provided they be imposed on proper objects, and kept within reasonable limits, they do not appear to be open to any good objection.

We may refer, in illustration of this statement, to the duties on malt, spirits, wine, and tobacco. These produce a very large annual revenue; and though some of them might, perhaps, be advantageously reduced, they appear—supposing them to be properly assessed—to be, in all respects, unexceptionable. Other duties

of this description, such as those on saddle horses, carriages, and livery servants, fall only on the more opulent classes. But this is not the case with the more productive duties; and it must be admitted that the largest portion of the revenue derived from them is paid by the lower and poorer orders. This, however, is not, as has been often alleged, a consequence of the latter being overtaxed, but of their being so very numerous that the produce of taxes to which they generally contribute invariably exceeds the produce of heavier taxes falling exclusively on the richer classes. The duties now under consideration act, in fact, as a species of improved sumptuary laws, having all the useful with few or none of the injurious influences of these regulations. . . .

But though it will, perhaps, be generally admitted that reasonable duties on spirits, tobacco, and such like articles, cannot be justly objected to, it may be contended, with some show of reasoning, that duties on necessaries, or on bread, butchers' meat, salt, tea, sugar, etc., are unjust and unfair, because of their being indispensable to the consumption of the poor as well as the rich. The injury, however, which is done to the poor by moderate taxes on necessaries is more apparent than real; for, as will be afterward shown, wages are, in most cases, increased proportionally to the amount of such taxes. And it commonly, also, happens that the quantity of an article used previously to this being burdened with a moderate duty, may be diminished, or something else be substituted in its stead, or the duty be defrayed by the exercise of greater economy or industry, without entailing any very serious privations on the consumers.

Without, however, insisting on these considerations, we deny that taxes on necessaries can be fairly objected to on the ground of their being unjust. They may, if carried to too great a height, be oppressive, and they may sometimes, perhaps, be inexpedient; but the charge of injustice is not one that can ever be truly made against them. Government has nothing to do with the means of the parties who buy taxed articles. It has done its duty when it has imposed equal and moderate taxes on the articles best suited to bear taxation. Providence has not been charged with injustice because the corn and other articles used indifferently by the poor and the rich cost the one class as much as they cost the other. And, such being the case, how can it be pretended that governments, in laying equal duties on these articles, commit injustice? A rich man will, of course, pay taxes, and everything else, with less inconvenience than one who is poor. But is that any reason why he should be unfairly treated? or mulcted of a part of his fortune, by being subjected to peculiarly high rates of taxation? Riches are an evidence of superior good conduct; for, in the vast majority of cases, they are the result either of their possessors having themselves been, or of their having succeeded to progenitors who were, comparatively enterprising, industrious, and frugal. The distinction of rich and poor is not artificial. It originates in, and is a consequence of, the differences in the character and economy of individuals. A government which should attempt to obliterate this ineradicable distinction by varying duties so as to increase their pressure on the more opulent classes would be guilty of flagrant injustice. And it would,

unsuitable

by discouraging the exercise of those virtues which are most essential to the public welfare, do its best to sap the foundations and weaken the springs of national prosperity and civilization.

So long, therefore, as duties are imposed on proper objects, and not carried to too great a height, we have yet to learn on what grounds they can be fairly objected to. A revenue must be raised by one means or other; and we are sanguine enough to believe that it will be sufficiently demonstrated in the sequel that such portion of it as may be raised by consumption duties will be the least onerous.

* * * *

It has been contended by Say, and some other economists, that taxes on income should be imposed on a graduated scale, and made to increase according to the increase of the incomes subjected to their operation. And the countenance which has been so frequently and cordially given to proposals for the introduction of property and income taxes by the more dangerous class of politicians has originated in their supposing that they might be made to embrace a plan of graduation. And, though in the last degree objectionable, it is not to be denied that there is something exceedingly plausible in this plan. A tax of £10 is said to be more severely felt by the possessor of an income of £100, or of a property of that amount, than a tax of £100, or £1000, by the possessor of an income or of a property of £1000 or £10,000; and it is argued that, in order fairly to proportion the tax to the ability of the contributors, such a graduated scale of duty should be adopted as should press lightly on the smaller class of properties and incomes, and increase according as they become larger and more able to bear taxation. We take leave, however, to protest against this proposal, which is not more seductive than it is unjust and dangerous. No tax on income can be a just tax unless it leaves individuals in the same relative condition in which it found them. It must of course depress, according to its magnitude, all those on whom it falls; and it should fall on every one in proportion to the revenue which he enjoys under the protection of the State.[2] If it either pass entirely over some classes, or press on some less heavily than on others, it is unjustly imposed. Government, in such a case, has plainly stepped out of its proper province, and has assessed the tax, not for the legitimate purpose of appropriating a certain proportion of the revenues of its subjects to the public exigencies, but that it might at the same time regulate the incomes of the contributors; that is, it might depress one class and elevate another. The toleration of such a principle would necessarily lead to every species of abuse. That equal taxes on property or income are more severely felt by the poorer than by the richer classes is undeniable. But the same is true of every payment which does not subvert the existing relations among the different orders of society. The hardship in question is, in truth, a consequence of the inequality of fortunes, and to attempt to alleviate it by adopting a graduated scale of duties would really be to impose taxes on the wealthier part of the community for the benefit of

[2] That is, of course, supposing all revenues reduced to the same denomination, or to perpetuities.

their less opulent brethren, and not for the sake of the public revenue. Let it not be supposed that the principle of graduation may be carried to a certain extent, and then stopped.

Nullus semel ore receptus
Pollutas patitur sanguis mansuescere fauces.

The reasons that made the step be taken in the first instance, backed as they are sure to be by agitation and clamor, will impel you forward. Having once given way, having said that a man with £500 a year shall pay 5 per cent, another with £1000 10 per cent, and another with £2000 20 per cent, on what pretense or principle can you stop in your ascending scale? Why not take 50 per cent from the man of £2000 a year, and confiscate all the higher class of incomes before you tax the lower? In such matters the maxim of *obsta principiis* should be firmly adhered to by every prudent and honest statesman. Graduation is not an evil to be paltered with. Adopt it and you will effectually paralyze industry and check accumulation; at the same time that every man who has any property will hasten, by carrying it out of the country, to protect it from confiscation. The savages described by Montesquieu, who to get at the fruit cut down the tree, are about as good financiers as the advocates of this sort of taxes. Wherever they are introduced, security is at an end. Even if taxes on income were otherwise the most unexceptionable, the adoption of the principle of graduation would make them about the very worst that could be devised. The moment you abandon, in the framing of such taxes, the cardinal principle of exacting from all individuals the same proportion of their income or of their property, you are at sea without rudder or compass, and there is no amount of injustice and folly you may not commit.

8

HARLEY L. LUTZ

Criticism of Progressive Taxation

A CONTEMPORARY criticism of progressive taxation by Professor Harley L. Lutz is stated as follows: *

Progression in taxation means that method of adjusting the tax rates whereby the rate becomes greater as the size of the tax base increases. Its principal use in this country is for the taxation of incomes and estates.

* Reprinted by permission from *Guideposts to a Free Economy* by Harley L. Lutz, copyrighted 1945, by the McGraw-Hill Book Company, Inc. (Chap. 9).

As applied in the case of the income tax, it means the taxation of the first installment or section of an income at a certain rate, taxation of the second section of the income at a higher rate, of the third section at a still higher rate, and so on. This method is found in the income surtax, and the surtax income brackets constitute the sections or portions of income that are taxed at the various rates.

It should be noted that, in practice, the tax rates are not progressive throughout. It is customary to exempt a certain amount of income at the bottom of the income scale, although this is a purely conventional concession, and its allowance has nothing to do with the theory of tax progression. It is also customary to halt the progression at some point short of 100 per cent, but this likewise has nothing to do with progressive tax theory. In the 1944 Individual Income Tax Act the top rate of surtax is 91 per cent, levied on all surtax net income in excess of $200,000.

The advocates of progressive taxation fall into two major groups. One group consists of those who see in this method of taxation a means of providing public revenue according to some standard which they regard as equitable. In the other group are those who regard it as an excellent device for the destruction of the private enterprise system and the inauguration of a socialist regime.[1] Unfortunately, the effects of progressive taxation are not dependent upon, nor determined by, the motives of those who believe in its use. In consequence, the first group becomes, unwittingly, a collaborator with the second group, although its members would indignantly deny any affiliation or sympathy of purpose.

Those who regard progressive taxation as a proper and suitable method of determining the respective contributions of the citizens toward the support of government usually base their case upon the ability-to-pay doctrine. They interpret this doctrine to mean that the person who has a large income is better able to pay tax than the person who has a small income. This ability, it is assumed, increases faster than the size of the income; hence it is concluded that the tax rate must likewise increase with the size of the income in order to keep pace with the growth in ability as income expands.

The difficulty with this theory is that there is no standard by which to distinguish a good progressive tax rate scale from a bad one. That is, there is no way of deciding upon the particular scale of rates and the particular size of income brackets to which these rates apply, in order to achieve the most equitable relation of tax burden to ability. It is impossible to ascertain just how much faster ability increases than income, and there can be no certainty whatever that the relation between ability and income is the same in the case of all individuals or in the case of different kinds of income. On the contrary, it is extremely likely that the ability-income ratio varies greatly among individuals having the same income, and that it varies greatly among different kinds of income.

Since the Federal income tax began, in 1913, the progressive surtax rates have varied as follows: In the

[1] In the *Communist Manifesto*, written by Karl Marx and Friedrich Engels in 1847, these significant proposals occur:

"A heavy progressive or graduated income tax;

"Abolition of all rights of inheritance."

act of 1913, the surtax began at 1 per cent on net income from $20,000 to $22,000 and rose to 6 per cent on income in excess of $500,000. In the act of 1926, the surtax started at 1 per cent on the income between $10,000 and $12,000 and rose to 20 per cent on income in excess of $100,000. Under the acts of 1936 and 1938, the surtax rate was 4 per cent on the income between $4,000 and $5,000 and 75 per cent on the income in excess of $5,000,000. In the war tax acts, the progression has been steepened greatly.

It has been characteristic of the Federal income tax that the income installments or income brackets have been much smaller in the lower than in the higher levels of income. Thus, rate increases have ordinarily been made with each $2,000 of additional income up to $16,000 or $18,000. Thereafter the income brackets have been widened for a time to $4,000, then to $6,000, to $10,000, and finally to $50,000 or more as the size of the income increases. Interpreting these income brackets and tax rate increases in the light of the ideological defense of progressive taxation, it would appear that the ability to pay income tax increases most rapidly in the income range from $4,000 to $18,000 and that this ability decreases relatively thereafter as the total income increases.

Since there is no standard whereby a choice can be made among progressive rate scales, it follows that one scale is just as good as any other as an application of the principle. A progression that rises to a tax rate of 100 per cent on all income in excess of $25,000, or even in excess of $5,000, is quite as defensible in terms of the vague and half-baked theory on which the entire system rests as one that imposes a top rate of 5 per cent on all income in excess of $1,000,000.

Advocates of progression as a revenue device will contest the preceding statement on two grounds. First, it will be said that the revenue needs should determine the precise scale used and that a perfect adjustment to ability at all times is not necessary. On the hypothesis that some progression is always better than none, this view would provide for the tax to approach as near to some highly theoretical standard of ability as the budget requirements might demand. Presumably also, it would allow for relaxation of the tax rate scale in periods of budgetary surplus. That is, the scale actually used at any time would be entirely a matter of revenue expediency.

But, there is a long-range view as well as a short-range view of the revenue aspect. Temporarily, it is always possible to squeeze a little more revenue out of the larger incomes, a process limited only by the amount to be realized through their complete confiscation. The principal effect of the modifications of the income tax during the 1930's was an addition to revenue by more squeezing at the top and a steady movement toward the goal of complete confiscation above some moderate income ceiling. In the long run, an excessive progression of tax rates is quite capable of destroying the revenue productivity of any tax base to which it is applied.

Second, it will be said that the progressive rate scale should always be reasonable. But, what is a reasonable progression? To those who have less than $5,000, it may seem entirely reasonable that no one should be permitted to have more than that amount after taxes.

The obvious fact is that, viewed simply as a revenue device, progressive taxation is an extremely dangerous fiscal instrument for the reason that there are no natural or self-operative checks to guard against abuse. The American experience reveals that there is no degree of progression beyond which those not affected by the progressive rates would be moved to protest on the general ground of inequity. There is no convincing basis for such protest under any scale of rates, since no one knows anything about the relation of so-called ability to income. The only logical stopping place, according to the current ability theory, is at the complete equalization of incomes by a confiscation of all incomes in excess of the lowest amount received by any one. As long as any inequality of income remains, it can be as plausibly argued that these larger incomes, however small their absolute amount, indicate some excess of ability to be levied upon, as it can be that existing inequalities of income indicate differences in ability.

But, even as a revenue device, the current application of progression is a fraudulent form of taxation according to ability. Since the ability doctrine as now applied postulates that all the items of income received over a fiscal period of 12 months must be added in order to determine just how able the several individuals are to pay tax, the taxpayers are obliged to defer final ascertainment of their tax liability until after the close of the period in which the income was received. This process naturally compels them to delay tax payment until the income to be taxed has been spent or is likely to have been spent. In reality, this is the reverse of taxation according to ability, for ability comes with the receipt of income and goes with its spending or other disposition. There can be no kind of taxation according to ability which does not recognize the fact that once income has been spent, invested, lost, or otherwise disposed of, all that remains is the record of what was received. For a large proportion of the taxpayers, the present policy of progressive taxation is no more than the taxation of a sum in arithmetic.

The current Tax Payment Act requires quarterly estimate and payment of income tax, including surtax, but it preserves the fiction that ability is measurable by the annual income total by requiring a year-end computation of total tax.

Because there is no sure definition of the limits to progression, no firm basis of its "reasonable" use, no protection against its unconscionable abuse, those who uphold the system as a revenue device are playing into the hands of the group that would use progressive taxation as the means of destroying private capitalism and ushering in the collectivist state. Here, at any rate, is a clear case for tax progression, the only clear case for it that can be made. In this view, the more drastic the tax rate scale, the more quickly and certainly will the desired result be accomplished. For progressive taxation can and will produce these results, and the arguments of those who wish to apply it to this end make far better sense than do those used by the Pollyanna tax theorists who seem to believe that it is possible to eat the seed corn and also, at the same time, to plant it.

The destructive effects of severe progressive taxation should be apparent to all who are capable of even a slight understanding of the nature and the operation of the present eco-

nomic system. It is of little avail to plead that this method of taxation should never be carried to such an extreme, for experience has demonstrated that it inevitably will be so extended, since those who presumably benefit vastly outnumber those who are most effected by it. As one writer has put it, the popularity of progressive taxation is traceable in no small part to the opportunity that it affords to place added burdens on the group which, while economically strong, is often politically weak.[2]

Among the essentials for the vigorous operation of the private enterprise system the following are significant here:

1. The provision of a large and ever-increasing supply of capital.

2. The application of this capital in a great variety of enterprises involving varying degrees of risk.

In order to assure the requisite flow of funds into the creation of new capital and the maintenance of existing capital, it is necessary that those who successfully weather the risks involved should be permitted to keep such profits as are received as a result of that success.

Progressive taxation can be, and usually is, pushed to a point at which these conditions for the maintenance of private enterprise in a vigorous and flourishing condition can no longer be met. The virtual confiscation of all income above a moderate level robs the capital fund of its principal source of supply, and at the same time it destroys the incentive to take the risks of new or hazardous investment. Having thus paralyzed the process of private saving, investment, and initiative, it becomes an easy matter for the government to assume, first, control, then ownership and direction of the economic factors of production. The most elementary principle of aggression in any sphere is to soften the opponent before engaging him in conflict. Progressive taxation is the most effective possible way of softening the enterprise system before moving in to take it over into a collectivist regime.

At this point a curious lapse in logic suffered by the ability theorists is of definite value to the collectivist cause. It is frequently said, in justification of steep progression, that the person with a large income will still have enough left, after paying the tax, to provide for his personal needs. Hence, the conclusion that even very heavy tax progression can involve neither injustice nor harm to the economic system.

If it were true that there is no other important use for income than to minister to the personal gratification of its recipient, then the case for government expropriation of it would be on better ground. But, there is another highly important use for income in the support and enlargement of the capital fund. This use is so vital to the maintenance of production and to the advance of the general well-being as to be superior to any use that government is likely to make, in ordinary times, of the funds so taken. Public expenditure of the proceeds of progressive taxation is for ordinary current operating purposes, and the proportion of the tax revenues spent to create self-sustaining public enterprises is negligible. Private investment of these funds adds to the nation's productive capacity. The effects of the public current-purpose spending quickly wear off, while the effects of private-investment

[2] R. M. Haig, article on "Taxation" in *Encyclopaedia of the Social Sciences* (1934), XIV, 539–540.

spending endure while the capital goods thereby provided remain in use.

A curious but impressive parallel may be cited to support the above statement. Mass unemployment, as a chronic phenomenon, has appeared in England, the United States, France, and Germany concomitantly with the increasing weight of progressive taxation of incomes and estates. A vicious spiral has operated as follows: Under the paralyzing effects of progressive taxation, the driving force of enterprise was weakened and a relief problem emerged. The effort to provide funds for relief through heavier taxes on the "rich" increased the volume of unemployment and made more relief necessary. The more these taxes "soaked the rich," the more unemployed there were for whom provision had to be made. Unemployment cannot be lessened merely by providing relief. The way to reduce it is to provide more jobs; the way to provide more jobs is to stimulate enterprise to engage in production; and the way to stimulate enterprise is to give assurance that those who take the risk of investing capital and producing goods shall be permitted to keep a substantial part of such earnings as they may receive. The present methods of taxation provide definite assurance to the exactly opposite effect, viz., that he who makes a dollar in business must expect to surrender a large part of it to the government.

If it were not for the element of class prejudice and class hatred introduced by the socialist controversy, it would be much easier to gain general support for the proposition just stated. There is excellent ground for believing that with a restoration of the incentives that motivate and energize the private enterprise system, jobs can and will be provided for all who are willing and able to work. True, this will mean that some will have larger incomes than others, but the most important thing is that everyone will have more income, and will be able to enjoy a higher standard of living in terms of real income, than will be possible while enterprise languishes in the straitjacket of repressive and burdensome taxation. It is impossible to conceive of a program that would more effectively vitalize and energize the productive forces in this country than the announcement of a firm and definite public policy of eliminating the excesses and abuses of progressive taxation. The National Resources Planning Board issued the prospectus of a huge program for the postwar period which omits all reference to the fundamental issue of tax reform and relies entirely upon further large deficits, a vast expansion of the public debt, widely extended paternalistic supervision, and control of economic activities. This program, coupled with the prospect of continued paralyzing taxation and public debt inflation can induce only resignation and despair.

It would seem a fair and reasonable statement that the remarkable advance of the American scale of living in the past generation has been made possible by the rise of a long list of large industries—concerns large enough to develop and apply the methods of mass production. The history of American business makes it clear that the typical and characteristic way of creating large business units is by the "plowing back" of earnings, the reinvestment of profits. It is true that in this process some persons may eventually amass substantial, even large, for-

tunes; but the continual growth of a business through the process of reinvestment of earnings has resulted, over and over again, in a large volume of employment, a huge total of wages, and a steadily lower price for some article that contributes to the comfort, the pleasure, and the well-being of millions of consumers.

One way to visualize the paralyzing and destructive effects of progressive taxation is to assume that this kind of tax system, even with rates such as were levied in 1938 and 1939 (i.e., prior to the war tax acts), had been in effect since 1900. Then, on the basis of this assumption, one should ask, How many automobiles would this country have today and at what price would they sell?

In this writer's opinion, the answer is clear. There would be only a few, and the price would be high. Certainly, there could have been no such growth and development of the automobile industry as actually did occur. The record of Henry Ford should provide convincing proof. The manner of the growth of the Ford Motor Company is well known. It was created entirely by "plowing back" the earnings. A tax system that would have taken a large part of these earnings for the current and, possibly, the foolish expenditure purposes of government since 1900 would have effectively stunted the growth of this company. Such a result would have had the approval of those who set the equalization of wealth and income above every other consideration, but it would have been a great tragedy for the millions who have had their living standards expanded by the incomes created by Henry Ford and by the pleasure and convenience of the sturdy, inexpensive, highly practical automobile that this great pioneer in a great industry was able to produce.

The world of the future has many other potential products that can and should be made available for all. While the people are so shortsighted as to retain a tax system that so effectively and completely destroys both the source of the capital funds and the incentive to search out the best and cheapest form of these products as does progressive taxation, they can no more materialize than could the automobile, if Henry Ford had been obliged from the beginning, to give over to the government 88 per cent of all income in excess of $200,000 a year.

The American people face a serious choice here, one that involves their destiny as certainly as any foreign battlefield or postwar peace conference. Concretely and in terms of an historical parallel, it is the choice between the Ford fortune and the Ford automobile. If they should decide that there shall be no more fortunes, they will also thereby decide that there shall be no commodities of mass comfort and enjoyment other than those now known. A few large fortunes would appear to be a small price to pay to gain the full benefit for all the creative and productive capacity that can be stimulated most effectively and most certainly by allowing those who succeed to keep the fruits of their success.

F.W. TAUSSIG

Justification of Progression

PROFESSOR F. W. TAUSSIG accepted progressive taxation, but solely on the ground of dissatisfaction with the distribution of wealth and income. He said: *

The courageous advocates of progression base their views precisely on the ground that the existing social order is not perfect and that taxation should be one of the insuruments for amending it. Even tho it be an open question whether all inequality in wealth and income be unjust, such great degrees of inequality as the modern world shows are regarded as not consonant with canons of justice. Very rich persons should be called to pay taxes not only in proportion to their incomes but more than in proportion. This proposal has been called socialistic; and it is, if all measures looking to mitigation of inequality be so called. Those who hold it place progressive taxation in the same class with free education, factory legislation, regulation of monopolies, extension of government management,—measures all of which are based on a desire to improve the social order in the direction of less inequality. The extent to which they are willing to go with progression no doubt depends on the degree of their fervor for social reform in general; nor are they themselves able to give a precise answer to the question often asked, how far is progression to go? Their opponents have urged, to use a much-quoted phrase of McCulloch's, that when once you diverge from the rule of proportion you are at sea without rudder or compass. The same difficulty might be urged against all sorts of movements for reform. Few except the rigid and extreme socialists have clear notions as to their ultimate goal. It suffices for the average man to know in what direction he is moving. Most unsophisticated persons in the advanced countries of modern times, tho they have very hazy ideas about taxation and socialism and economics in general, will instinctively declare it "right" that the rich should contribute to the public burdens, as compared with the poor, not only in proportion to their incomes, but more than in proportion. In so saying, they show that influence of the spirit of the time from which none of us can escape.

* From *Principles of Economics* (4th ed.; New York: The Macmillan Company, 1939), pp. 539–540. By permission of The Macmillan Company, publishers.

matically brought about by the interest rate has been exploded. Of course, the tax system can affect the demand for, as well as the supply of, savings. It can preserve a wide market for the flood of goods produced by our improved economic mechanism. It can also sustain incentives for investment, thus facilitating expansion which develops demand for consumption goods as it proceeds. Just what combination of taxes and tax policies will prove the best answer to this problem of balancing saving, spending, and investing is by no means certain. But it would be a grave mistake to renounce finally any of the fiscal powers we may need to solve the problem.

It can be argued with some plausibility that to tax high incomes at rates above 25 percent is injurious to the economic incentives and that it leaves inadequate rewards for industry and thrift. However, it is highly doubtful that any such ceiling is required for incentives, and there are other ways to safeguard the interest in investment—more generous allowance for losses and the elimination of tax-exempt securities, for instance. But even if this argument were conceded for a ceiling rate on income, it would surely be unconvincing as applied to estates. Capital received by inheritance is not earned income nor has the heir, in most cases, demonstrated his fitness to serve as trustee over large resources. Equality of opportunity and the ends of a dynamic economy would best be served were the heir to start where his benefactor began and earn his own fortune. Since the time of John Stuart Mill, many conservative economists have been skeptical of the social justification of inheritance. However, one can accept the institution of inheritance and still view with alarm any attempt to elevate it to a position in the Bill of Rights along with free speech and the right to worship God as one chooses.

The author's purpose is not to argue that income and estate taxes can never be pushed too high. It may well be that postwar surtaxes should be moderated, or, more important, that the double taxation of equity earnings now embedded in our tax system should be mitigated or eliminated. The public is now in a receptive mood for disinterested proposals that offer plausible promise of bearing a favorable influence on production. Public opinion is not always a wise and fair judge, but it is the safest guide to public policy in the long run.

V. *The Ceilings and Progressive Taxation*

The proposed amendment would have the effect of blocking most, if not all, application of progressive taxation in the federal tax system. There was a time, of course, when progressive taxation was regarded as a revolutionary threat to the economic virtues and the stability of economic institutions. But this type of taxation is now accepted in nearly all, if not all, of the well-developed nations. None of them, to the author's knowledge, has ever seriously considered a constitutional ceiling for income and estate tax rates.

The proper impact of the tax system on the distribution of wealth and income is a controversial question upon which reasonable men may differ. At present, the extreme left calls for a ceiling on income and the extreme right for a ceiling on taxes. The issue here is whether any view on this problem is so obviously right and so certain to endure that it

should be written into the fundamental law of the land—the Constitution.

The universal franchise combined with progressive taxation is an explosive mixture, fraught with revolutionary potentialities and possibilities of abuse. But great concentration of income, wealth, and economic power is likewise dangerous and full of revolutionary possibilities. Excessive economic power means not only a high degree of control over the economic lives of large numbers of people; it also involves domination of such social institutions as the church, school, newspaper, and radio. A democratic people may resent economic as well as political dictators.

Progressive taxation is a safety valve for releasing steam that might otherwise force unwise revolutionary changes. Or to put it another way, those who pay high taxes can think of them as a desirable form of insurance against something a great deal worse. A tax system, to be reasonably stable, must satisfy the American conscience; and that conscience is becoming more, not less, sensitive to inequalities than in the past decades when our tax system was evolving.

Democracy is an institution which allows each qualified voter to express his views both of his own interest and of the general interest. Decision by counting ballots, by the weight of numbers, undoubtedly has its limitations. Certainly "the masses" are far from infallible in their judgment. But the judgment of the masses on a matter like the distribution of the tax load is likely to be better than that of any special group with a very intense special interest. The American people may think that more equality is necessary for, or not incompatible with, or preferable to, a high rate of economic progress; they are entitled to their choice. They are also entitled to change their minds on the basis of the results of the experiment. Socialized consumption may or may not be the best means of enjoying an economy of abundance. But this again is clearly a matter for the voter to decide. The large income recipients should be compelled to face the bar of public opinion like others in the community and should not be entitled to any special constitutional immunities.

BIBLIOGRAPHICAL NOTE

A summary and criticism of the earlier literature on theories of tax distribution will be found in Professor Seligman's *Progressive Taxation in Theory and Practice,* from which selection 6 in Chapter 1 is taken. For modern text summaries of the issues see Harold M. Groves, *Financing Government* (New York: Henry Holt and Company, Inc., 1946), Chap. 2; Alfred G. Buehler, *Public Finance* (New York: McGraw-Hill Book Company, Inc., 1940), Chaps. 15 and 17. The reader will profit much by reading the full text of Seligman's "The Social Theory of Fiscal Science," of which selection 1 of this chapter gives only a fragmentary sample. An examination of the place of incentives in the tax problem can be found in Harold M. Groves, *Postwar Taxation and Economic Progress* (New York: McGraw-Hill Book Company, Inc., 1946), Chaps. 1 and 11. Further exploration of the extensive literature on the subject of "equality" is recommended. Particularly valuable here will be

Frank D. Graham's *Social Goals and Economic Institutions* (Princeton University Press, 1942), and R. H. Tawney's *Equality* (London: Allen & Unwin, 1931). Legal and constitutional aspects of progressive taxation are discussed in *Magoun* v. *Illinois Trust and Savings Bank,* 170 U.S. 283 (1898) and *Knowlton* v. *Moore,* 178 U.S. 49 (1900).

CHAPTER 2

THE GENERAL PROPERTY TAX

UP TO the present, except for war periods, the general property tax has been by far the most important member of the tax system in the United States. It has been particularly outstanding as the main and frequently the sole support of local government units. It is also the tax which has withstood probably more constant and emphatic criticism than any other.

Applying the norms discussed in the preceding chapter, critics find property a very rough gauge of benefits received and an even less defensible index of ability to pay. But the property tax is supported as perhaps the best available independent source of local revenue. In other words, it enables local residents "to spend their own money" as they (collectively) see fit.

The administration of the property tax, however, has been of greatest concern. The fact that we include personal property (tangible and sometimes intangible) in the base greatly increases the difficulty. Then, too, there are the grievous problems associated with local administration and the use of the same tax (and frequently the same tax base) to serve different levels of government. Finally, the thorny field of value and valuation must be encountered in property taxation.

The property tax has undergone a slow but steady evolution in the United States, and its modifications differ substantially from state to state. Some states have developed improved administrative devices such as central supervision and equalization. Others have sought to solve the property-tax problem by classification, treating various forms of property with different rates or scales of assessment. Still others, especially since the depression of the thirties, have experimented with over-all rate ceilings and homestead exemptions.

This chapter draws from an extensive literature to analyze and criticize the property tax, particularly at its high points of interest stated above.

JENS P. JENSEN

Concepts of Taxable Property

PROPERTY-TAX study properly begins with an analysis of the concept of property for tax purposes. This aspect of the subject is treated by Professor Jens P. Jensen as follows: *

It has been shown that property is, and usually has been the principal tax base for state and local purposes in the United States. A general analysis of the suitability of property for this purpose will be undertaken here. Briefly stated, what is sought is an answer to the question: Is it economically expedient to raise 80 per cent or more of the state and local tax revenue in the form of taxes on property, under existing and probable economic conditions? The answer must be based on pertinent facts and general economic principles.

I. *Concepts of Taxable Property*

For the purpose of such analysis it is important to have in mind a definite, rational concept of taxable property.[1] None of the existing American state property tax systems exemplifies such a concept. The systems are patchworks, adaptations of confused ideas to meet diverse local conditions, often sanctioned without a clear understanding of the nature of property or taxes. The hybrid concept apparently underlying every state system is composed of parts of two widely different concepts, each of which alone would satisfy the rational requirement that all property should be taxed once and only once, but which in unreconciled combinations produce grotesque results in the form of multiple taxation and avoidance or evasion of taxes.

[1] In this volume no attempt has been made to treat at length the nature and concepts of property taxation in antiquity, during the Middle Ages, and in the recent past, outside of the United States. Students interested in those fields should consult Professor Seligman's chapter entitled "The General Property Tax," in his *Essays in Taxation* (10th ed.; New York: The Macmillan Company, 1925), which is elaborately documented, chiefly with the works of German scholars.

Attention may be called to the work of Bruno Moll, *Probleme der Finanzwissenschaft* (1924), especially to Chapters 12 and 13. In these two chapters Moll discusses the concept of property taxation and its relation to income taxation.

For an excellent summary limited to one country Professor C. J. Bullock's paper, "The General Property Tax in Switzerland," in *1910 Proceedings*, pp. 53–84, and reprinted in his *Selected Readings in Public Finance* (3d ed.), pp. 350–79, outlines a property tax system, or a congeries of systems, nearer to those existing in the United States than any other, yet differing in important respects, the principal one being that the Swiss property taxes are relatively less important fiscally than those of the United States.

* Reprinted by permission from *Property Taxation in the United States* (Chicago: University of Chicago Press, 1931), pp. 48–53.

From what may be called, somewhat arbitrarily, the legal point of view, property consists of rights in or control over economic goods. Courts find it necessary, however, to recognize the popular use of the term "property" to designate material things which may be the "subjects" of ownership: [2]

> The term "property" has a most extensive signification, and in its strict legal sense means that dominion or indefinite right of user and disposition which one may lawfully exercise over particular things or objects. But the word is often used to indicate the subject of the property or the thing owned, as a chattel or a tract of land. These things, however, though the subjects of property, are, when coupled with possession, but the indicia, the visible manifestations, of invisible rights, the evidence of things not seen.

The economist faces the same necessity for distinguishing between "wealth" and "property." Wealth consists of material things plus such incorporeal rights as do not diminish the rights of others in material things. Such rights as patents, royalties, trade marks, good will, franchises, do not represent an interest in particular things owned by particular persons; they do not diminish the rights or interests of anyone in particular material goods. It is convenient to designate such rights as nonrepresentative intangible property, or merely as nonrepresentative intangibles. But the majority of rights in tangible or material things diminishes the rights of others in particular things. With land, where the most complete right or estate is that of fee simple, the debt of the owner secured by mortgage on the land *pro tanto* diminishes the equity of the owner in the particular parcel of land. There are many other rights in land which it is not necessary to mention here. They make the land worth less to the owner, because they diminish his rights or equity in it. Such rights may also exist in specific movable goods. Thus the equity of the owner in an automobile may be diminished by a chattel mortgage on it. But a great many rights are not secured by particular material things; they are not rights or property *in rem,* but *in personam.* Accounts and bills receivable, judgments, bank deposits, and a great many other rights are of this nature.

Obviously, all of these rights and interests have a value in exchange, more or less accurately ascertainable in the market. Such value constitutes theoretically a perfect measure by which to tax all property. No property can escape and there can be no double taxation if every person is taxed according to his net rights or equities.[3] If one person holds all the rights in anything, he can be taxed according to their full value; and no one else can be taxed in respect to any part of it. Such pyramiding of equities as results from the corporate form of business organization, or from the holding corporation, constitutes only an apparent exception if the practice of taxing only net equities is strictly adhered to. And, if there be division of the rights, then the sum of all the parts will equal the aggregate rights; and each holder can be taxed in proportion to his share of the whole. The property tax on this basis would be a tax on the net equities of the taxpayer, or upon the difference between his

[2] 22 *Ruling Case Law,* p. 37.

[3] Net rights in the sense of the positive difference between total rights and obligations.

assets and his liabilities.[4] It is a personal tax, imposed on the taxpayer in proportion to or in respect to the net value of his assets. The scheme is logical enough if the only requirement of the tax is that it must reach all property and must reach no part of it more than once. There are, however, other requirements of taxes and tax bases which render the consistent application of property rights as tax bases impractical and even impossible.

No less perfect as a tax basis than the lawyer's list of rights, is the list of tangible objects in the possession of each taxpayer, plus such categories of intangibles as good will and patent rights, which do not represent rights in particular tangible objects. If every unit of land, and every unit of capital goods, be taxed to the holder, then all property can be reached once, and once only. There can be no double taxation of property, and no property can escape. The list of tangible goods as a tax base would yield the same result as the list of rights therein, to the extent that either would reach all property, and do so only once. Such a tax, on things rather than on net equities, disregarding the economic condition of the taxpayer, corresponds, in fact, much more closely to the realities of American property taxation. It ought to be called a tax on possessions, although such a name would fail to describe accurately the existing state systems. Such is the impression of the only non-American scholar [5] who has attempted to study specifically the general property tax of this country. The American general property tax is an excellent example of a nation-wide institution, which touches the interests of the people at innumerable points, being designated by a name that has long since lost most of its significance.

Certain practical considerations have been regarded as rendering the exclusive and consistent use of either

[4] This is the concept of property, as a tax base, usually adopted by European scholars. Thus Professor Walther Lotz, *Finanzwissenschaft* (1930), p. 525, defines property as follows: "Unter Vermögen versteht die Theorie der Volkwirtschaftslehre für die Gegenwart den Geldwert der in Geld oder anderen Dingen bestehenden Sachgüter, über die einer Person ausschliessliche Verfügungsgewalt zusteht, sowie den Geldwert der einer Person zustehenden sonstigen Rechte, abzüglich der geschuldeten Summen, also Aktiva minus Passiva." A tax on property, so defined, is usually designated in German as "die Vermögenssteuer," and that is the word used in translating the words "general property tax," as used in the United States, into German, notwithstanding the fact that the American property tax is something far different. The French language has no single term for the concept under discussion and uses the phrase "Les impôts généraux sur la proprieté," or some similar set of terms. When European writers discuss property taxation, and, specifically, the general property tax, which they nearly always condemn severely, except as a supplementary tax of minor fiscal importance, they usually have in mind some actual or hypothetical system much more rational than the typical state systems in the United States.

[5] Bruno Moll, *Zür Geschichte der Englischen und Amerikanischen Vermögenssteuern.* On page 100 he says: "Wenn ich auch immer wieder betonen möchte, dass es mir in meinen Untersuchungen weniger auf den Namen ankommt, als auf die Sache, so glaube ich doch, dass es bezeichnender wäre, wenn man anstatt von den amerikanischen Vermögenssteuern lieber von 'Besitzsteuern' reden würde." Dr. Moll's reasons for preferring the term "Besitzsteuern" (taxes on possessions) to the term "Vermögenssteuern" (property taxes) are that (1) the former term is more definite in meaning than the latter, whose meaning is very general and uncertain, and (2) it reflects more accurately the actual practice, if not always the law, of American property taxation, which is in fact much more truly on things than on equities.

of the foregoing bases impossible. In the first place, property, objectively speaking, is not always or even usually owned in fee simple; it is owned ostensibly by the person in possession, while the principal equity may be held by someone else. In using ownership as the tax basis, the tax administrator would have to determine the net equities of every taxpayer; this is too frequently an impossible task.

In the second place, the actual owner, whether of complete or only partial estate in any good, may be a resident of one tax jurisdiction while the objective property is situated in another. The question then arises: Where are the taxes properly due? Both districts may be said to have some claim to contributions.[6] To tax on both bases would be equitable so long as both the nonresident and the resident owner are taxed on both the ownership basis and the objective basis. But, aside from the objection to the unnecessary cost of laying the tax on a double basis, such an arrangement would meet a practical obstacle in the attitudes both of legislators and tax administrators.

In the third place, certain properties, such as land and improvements, are more obviously taxable at their location than at their ownership; while, at the other extreme, most representative intangibles cannot well be taxed elsewhere than at the owner's residence. The tax laws consider now one place, now the other, as a taxable situs, and sometimes both. The confusion and multiple taxation that often result when the holder of a divided estate is taxed as if he were the holder of the undivided estate, with no allowance made for this fact in taxing the other partial holders, are widespread and serious. They would be much more serious were the tax laws effectively administered. So long as it be granted that all tangible and all nonrepresentative, intangible property should be taxed once and only once, it is not merely a question of administration whether the tax shall be paid by the equity-holders or by the person in possession or control of the property.[7] The choice of the taxable base, whether the equity or the possession of the goods, determines the distribution of the revenue among states and among localities.

In recent years, however, the view has been stressed that all tangible property and all nonrepresentative, intangible property should be taxed where it is located and presumably economically employed. In that jurisdiction is generated whatever ability to pay taxes—in so far as the generation of such ability may be assigned to a specific locality—the owner of the property may possess by reason of ownership and use of the property; and in that jurisdiction is enjoyed the benefits of public services. This doctrine of economic allegiance has recently received a stimulus from an unexpected quarter. The League of Nations and co-operating organizations have during the past decade considered intensively the question of international multiple taxation and tax evasion. The experts have found, as one of the by-products of their labor, that some of the principles involved are applicable to

[6] For a discussion of the problem of multiple taxation, see E. R. A. Seligman, *Essays in Taxation,* Chap. 4. Also Francis Walker, *Double Taxation in the United States.*

[7] In case of partly representative intangibles, such as corporate shares of stock, there is also the problem of ascertaining the extent to which they are such.

interstate and intrastate tax conflicts as well as to international ones.[8]

The basic concept of general property taxation adopted for analysis here is, accordingly, that in which all tangible, and all nonrepresentative intangible property is taxable on a uniform assessment ratio, at a uniform rate in each taxing jurisdiction, where the property is located or may be constructively located,[9] regardless of the division of equities and the residence of the owners of such equities.

12

EDWIN H. SPENGLER

The Property Tax as a Benefit Tax

PROCEEDING next to the theoretical aspects of the subject, we encounter the time-honored notion that property receives certain special benefits from governments and that the property tax may be justified as an equivalent for these benefits. Some services seem to fit this theory better than others. The property tax is treated from this angle by Professor Spengler as follows: *

Meaning of Benefit Tax

What is a "benefit tax?" In some quarters the expression would be considered redundant. The justification of all taxes is that they support the government in providing for the common good. There is thus a distinct benefit relationship between total tax revenues and public services rendered. If interpreted in the narrower sense, so that the term "benefit" denotes some specific service rendered to the taxpayer by the state, the expression "benefit tax" might be criticized as self-contradictory in character. It is generally agreed that a tax is a compulsory contribution exacted by governments from private individuals *without reference to special benefits conferred.* There is no necessary relationship between the amount paid by a taxpayer and the amount of benefit directly received. Thus, a distinction is drawn between taxes on the one hand and prices, fees, and other administrative revenues on the

[8] E. R. A. Seligman, *Double Taxation and International Fiscal Co-operation* (1928), and references there given.

[9] Nonrepresentative intangibles are usually constructively located at the domicile of the owner, as in the case of patent rights, royalties, good will, or franchise value.

* Edwin H. Spengler, "The Property Tax as a Benefit Tax," *Property Taxes* (New York: Tax Policy League, 1940), pp. 165–173. Reprinted by permission of the Tax Institute, New York.

other. In the case of a tax, in the pure sense of the word, the payments involve no *quid pro quo* to the taxpayer; the benefit is not susceptible of direct measurement and a particular advantage, if it exists at all, is an incidental result. Prices, and the several types of administrative charges, exhibit, in varying degree, differences in importance of individual advantage measured by special benefit, as contrasted with the common interest or public purpose.

In distinguishing between taxes and the somewhat less compulsory and more contractual revenues Seligman stated: "The essential characteristic of a fee is the existence of a measurable special benefit, together with a predominant public purpose: the absence of public purpose makes the payment a price; the absence of special benefit makes it a tax." [1] As individualistic theories of the state are modified or replaced by collectivistic doctrines the separation of the notion of private benefit from tax revenue grows more pronounced. The government is charged with the broad duty of promoting human welfare and social progress. Group welfare is put ahead of individual benefits. The contemporary viewpoint in taxation is thus "a product of the growing social solidarity and sense of common social obligation that have characterized human progress during the last hundred years. The contributory element in the modern tax concept emphasizes the greater social unity, and the stronger sense of common burden and responsibilities which are a feature of modern life. . . . This conception of the nature of taxation is inimical to the view that taxes are payments for specific services rendered to the taxpayer by the state." [2]

However, the survival of such non-tax revenues as public prices, fees and special assessments indicates that the principle of charging for measurable benefits has not altogether been abandoned in modern fiscal systems. Moreover, there appears to be a strong flavor of individual benefit in the handling of gasoline tax and old-age security tax revenues. In the former case the tax paid on gasoline consumption is rather closely related to the benefits derived from the use of public highways and the revenues collected from the taxation of motor fuels are usually devoted to highway construction and maintenance. Similarly, old-age benefit payments are computed in proportion to the tax contributions of the workers.

Here it seems possible to trace the benefit of certain governmental services to particular groups. It may, however, be argued, and rightly so, that the automobile owner is not the sole beneficiary of the highway and further, that the revenues from gasoline taxes are not always applied exclusively to highway funds. Or else it may be asserted that while present social security taxes are levied on the principle of "benefit in proportion to contribution" this does not justify the retention of the policy. Other countries of the world are known to provide pensions that bear no direct relation to the contributions of the beneficiaries.

Nevertheless, these examples would seem to indicate what we might call a kind of "twilight zone" between prices or administrative fees and taxes, where all the essential ele-

[1] E. R. A. Seligman, *Essays in Taxation*, p. 431.

[2] H. L. Lutz, *Public Finance* (3d ed.; New York: D. Appleton-Century Company, Inc., 1936), p. 317.

ments of taxation are present, but where some degree of specific or measurable benefit is recognized. A compulsory contribution may be required by the government from certain individuals or groups for defraying the general costs of public services, in exchange for which *the taxpayer is guaranteed no specific return;* yet, the handling of such revenues may be so directed that certain benefits are clearly traceable to the taxpayers in question. When such is the case, the tax is evidently a general revenue device which, partly because of public policy and partly for convenience in administration, has been substituted for a more complicated series of special fees or prices. Under circumstances where a charge for the benefits received does not defeat the very purpose of the expenditure, there would seem to be a legitimate basis for applying the cost of service or benefit principle. Such revenues are not taxes in the "pure" sense but are hybrid or "quasi-tax" measures conforming in general to the definition of a tax, but including certain features of the administrative fee or public price.[3] In this category belongs the so-called "benefit tax."

The General Property Tax

In what respects does the general property tax answer this description? In the early history of this tax, property was regarded as the best objective test of ability to pay. In pioneer agricultural communities the value of property therefore served as the base for most tax measures. However, in the transition from a simple to a more complex economy involving corporate structures and different varieties of intangible wealth, many well-known theoretical and administrative defects arose. As a result other objects of taxation, notably net income, were proposed as more acceptable tests of ability to pay. Without going at great length into the history of the general property tax, its present status in the United States may be summarized by saying that:

1. Property taxes are the main support of local governments and, in addition, provide about 6 per cent of state revenues.
2. Classified property taxes have been introduced to an increasing extent in an effort to adjust property taxation to changing conditions.
3. Property taxes have tended to concentrate on real estate, because of outright exemption of intangibles and other personal property, the taxation of this property at especially low rates, or its evasion. (In 1932 real estate represented 77 per cent of total assessed value of taxable property.)[4]
4. Urban real estate constitutes the largest percentage of taxable property in the United States. (Real estate assessed valuation in the ten leading cities alone exceeded 25 per cent of assessed value of all taxable real estate in the United States in 1932.)

Urban Realty Taxes

It would be correct, therefore, to conclude that while the question of "benefit tax" has been raised with respect to property taxes in general, the vital issue centers around urban realty taxes in particular. The steady rise in the costs of local government was occasioned not only by the growth of population but also through the assumption of new functions and the expansion of services al-

[3] See J. P. Jensen, *Government Finance*, pp. 171–2. See also R. Jones, *The Nature and First Principle of Taxation*, pp. 6 ff.

[4] A. G. Buehler, *Public Finance*, p. 301.

ready undertaken by municipalities. The special difficulties arising out of the depression intensified the problems of local finance and led to organized protests on the part of home-owners, real estate interests and taxpayers' groups against what they termed "unfair discrimination" in the taxation of one class of property for the support of government functions.

The possession of real estate has been taken almost universally by local jurisdictions as one index of the citizen's ability to contribute to the support of his local community. Yet, in the opinion of most authorities in public finance, the value of land and buildings is admittedly neither the sole nor the best test of ability to pay. It is, therefore, pertinent to inquire whether, from the standpoint of benefits received, this unequal distribution of the tax burden is at all justified. In other words, is the real estate tax of the hybrid type, including not only elements of "pure" taxation, but a series of charges for specific benefits received?

Classes of Benefit to Real Estate

Broadly speaking, there are two general classes of benefit to real estate from municipal expenditures:[5] (1) Direct services rendered. (2) Activities which produce desirable influences upon real estate values.

The first group consists of repetitive annual services. The second class is associated largely with capital outlays for public improvements which frequently exercise a favorable effect upon surrounding realty values.

In considering these elements of benefit it must be remembered that the property tax is essentially an *in rem* levy. Benefits should, therefore, be thought of primarily in terms of advantages to the property taxed. That the individual beneficiary is an owner-occupier, a tenant, or a speculator is of secondary importance. The significant question is whether the property is afforded services or given special advantages which make it so attractive to owners, tenants and speculators that, directly or indirectly, they are willing to pay a premium for its use or possession. In other words, are the services which are available to properties within the confines of a municipality worth the extra overhead which the cost of these public functions necessitates?

In the category of direct services are those governmental activities which help to make property more suited to the needs of those who wish to occupy, rent, or sell it. Such services include the collection of garbage, rubbish and ashes, and their disposal; the maintenance of storm sewers and sanitary sewers; flood control in sewered areas; the cleaning of sewers; and the operation of sewage disposal plants. In like manner, such functions extend to the repair of streets, highways, main roads or bridges; the sweeping and occasional flushing of paved streets; the scraping, oiling, and raking of dirt streets; the sprinkling of streets in hot, dry weather; the removal of snow and ice in cold weather; the pruning or spraying of street trees; the erection and care of street and road signs; and the maintenance of proper lighting on streets and roads. Municipal water systems and other public utilities which are

[5] Part of what follows has been drawn from a previous monograph. For a more complete discussion of this subject see E. H. Spengler, "Is the Real Estate Tax a Benefit Tax?" Memorandum No. 5 in *A Report of the New York State Commission for the Revision of Tax Laws*, 1932.

partly or fully financed through property tax revenues should also be counted among these services. Fire protection is another benefit, not only in the sense of the protection of property against loss but also with reference to the reduction of the costs of fire insurance. Police protection from the local village policemen to the state militia must also be considered of fundamental importance to the owners and users of property. Moreover, there is much direct benefit to property through such work as the satisfactory regulation of traffic, the elimination of grade crossings and proper planning and zoning of a city.

Most of these services are closely identified with urban life. In the less congested areas of the hinterland many of these services are not at all needed; in fact, life there is usually found to be more enjoyable without them. For those who continue to demand space within the more limited confines of a city, however, most of these functions have been found to be not only desirable, but increasingly necessary.

In addition to the services already mentioned, local governments pay a large annual bill for certain broad social programs such as the provision and maintenance of parks and playgrounds, schools, hospitals, libraries, museums, etc. These functions are a step removed from the idea of direct benefit to property. They are rendered from the standpoint of the collective group for the benefit of "persons" as such, rather than property. Indirectly, however, they may be considered as beneficial to property to the extent that they exert a favorable influence upon general property values. This same reasoning applies to innumerable capital outlays for fixed improvements. Wherever the physical presence of such improvements has the effect of favorably influencing property values (and the property is not locally assessed for the cost of this improvement) a distinct value benefit results.

Conclusions

The conclusion that may be drawn from the preceding remarks is that at least a part of the property tax revenue goes to pay for services and for capital investments which are of benefit, directly and indirectly to the property which is taxed. But what of it? Should the government in recognition of such benefits, adopt the procedure of imposing separate fees for its services upon all benefitted parties? Should the goal be to make as many municipal activities self-supporting as possible?

A policy of this kind would seem to be extremely undesirable—placing a premium on individualistic interests and reducing to a minimum the recognition of the social need for certain services. It would imply that one might refuse the benefits and therefore pay no fees. It would inflict great injustices in the light of prevailing inequalities in wealth and income. It is vital to recognize that the broad collective interest with respect to such services is paramount, even though in some instances there is present a clear element of individual benefit. In other words, the principle of taxation should be retained, even though it is a "benefit tax."

If it is felt that some services are more beneficial to certain classes of property than to others and that *each class is equally able to carry its respective tax burden,* the principle of classified taxation might be further extended. Thus, rising land values

which are recognized from time to time could be subjected to an increment tax; or land, which is the chief beneficiary in rising realty values, could be exposed to heavier tax rates than those chargeable to improvement values. A building tax might be justified for supporting the greater part of the burden of fire protection, or a sewer tax might be added to the water bill in terms of flow accommodation received. Although property would still be assessed for these taxes, the apportionment of burden in this way might be regarded as more equitable. Alterations of this variety in the property tax system must, however, be introduced with the greatest of care and should be based upon an intelligent understanding of their justification and significance.

13

CLARENCE HEER

The Property Tax as a Measure of Ability

THEORETICAL justification for the property tax may also be sought in terms of ability to pay. Professor Heer, however, finds scant support for the tax in this quarter. After discussing the meaning of the ability-to-pay concept, he proceeds thus to discuss its application to the property tax: *

* * * *

Place of Property Tax in Scheme of Ability Taxation

In the light of the above interpretation of the meaning of ability, we are now prepared to consider what place, if any, the property tax may appropriately occupy in a scheme of ability taxation. If by the property tax we mean the general property tax regarded as the sole element of a tax system, our consideration need not consume much time. American tax literature of the last 50 years is full of evidence to the effect that the general property tax under modern conditions falls signally short of meeting the requirements of the ability concept.

I shall not weary you with the repetition of a story which has long since become stale. As everyone knows, the practical impossibility under present-day conditions of administering the general property tax effectively, the lack of uniformity and precision in

* "The Property Tax as a Measure of Ability," *Property Taxes,* pp. 155–164. Reprinted by permission of the Tax Institute, New York.

assessments, the escape of intangibles and other mobile forms of personal property, and the administrative difficulties connected with the treatment of debts, all operate to make the general property tax both unequal and regressive. The failure of the general property tax adequately to reach the enormous volume of non-property income, and the frequent lack of correspondence between the market value of property and its income-yielding capacity contribute toward further violations of the ability formula. Since it is administratively impossible to determine the net worth of individuals, progressive taxation is ruled out.

All of the strictures against the general property tax which have just been enumerated apply when the tax is actually borne by the individuals upon whom it is levied. But the general property tax, as it is found today, is a general tax in name only. Large classes of property entirely escape its operation, either by virtue of express statutory exemption or by virtue of lax enforcement. The fact that the general property tax does not apply at uniform rates to all kinds of property in all parts of the country makes possible a considerable amount of tax capitalization and tax shifting. Such evidence as is available would seem to indicate that the final distribution of shifted property taxes in no sense conforms to the ability principle. Neither would there appear to be any correlation, inverse or otherwise, between the ability to shift property taxes and ability to pay.

The taxation of real estate constitutes the backbone of the general property tax in the United States. For the country as a whole real estate represented no less than 77 per cent of the total of all property assessments in 1932. Probably the largest single share of our property tax collections is derived from levies on residential real estate. This element of the property tax is in large part a tax on expenditure for housing. Individuals at the lower end of the income scale ordinarily spend a higher proportion of their income for housing than do those in the upper income brackets. Thus, according to the findings of the Brookings Institution, families with incomes under \$1,500 per annum spent on the average one-third of their income for shelter and home maintenance in 1929. At the other extreme, families with incomes over \$25,000 per annum spent on the average only 12 per cent of their income for these purposes in that year. It may be concluded from this that the property tax on residential real estate is a regressive tax, falling almost three times as heavily on the poor as on the wealthy.

Because farming operations require a comparatively large amount of real estate per dollar of income yield, a substantial portion of the property tax in the United States is collected from farm owners, a low income group. Because of his inability to control the supply of his products, it is extremely difficult for the farmer to shift his taxes. Capitalization, on the other hand, offers a means of escape only to the new entrant into the ranks of farm owners or to the farmer who is increasing his holdings.

A third important share of property tax collections in the United States is derived from levies on business property including the property of public utilities. The incidence of this part of the tax is not uniform

but to the extent that it is added to prices and passed on to the consumer, it becomes in effect a tax on expenditure and, hence, regressive when measured by the ability standard.

Although the general property tax considered by itself is obviously regressive, the fact is that property taxes in the United States are found in conjunction with highly progressive income and inheritance taxes. This raises the question of whether the property tax, or at any rate a tax on real estate, cannot be justified as a convenient way of shifting a part of the tax burden to the large group of individuals with incomes below our present liberal limits of income tax exemption. There are several reasons for answering this question in the negative, but only one of them must suffice.

With respect to incomes above the level of income tax exemption, roughly incomes above $2,000, the distribution of our tax burden, as shown by the admirable recent study of the Twentieth Century Fund, Inc., is distinctly progressive. This result is brought about by our steeply graduated income and inheritance taxes. As regards income groups below $2,000, however, our present tax system is regressive. In other words, families with incomes averaging around $500 per annum actually bear a relatively heavier burden of taxation than do families with $2,000 incomes. This reversal of the rule of ability taxation is due in large part to the regressive effects of shifted property taxes. Since over four-fifths of all families and unattached individuals in the United States have incomes of $2,000 or less, it is apparent that the vast majority of our population, despite the income tax, is subject to regressive taxation. It is unnecessary to add that progressive taxation covering a fifth of the population at the upper end of the income scale constitutes no justification for regressive taxation of the remaining four-fifths of the population.

Since the ability principle calls for higher taxation of income from property than of income from personal effort, it might be asked, finally, whether a general property tax in conjunction with a personal income tax might not be justified as a way of placing the desired additional burden on property income. The answer to this question must be another negative, since from an administrative point of view it is much easier to apply the differential rate directly through the income tax.

To summarize the entire discussion, there appears to be no place for the property tax in a scheme of ability taxation. This is not to say that the property tax, or at least the tax on real estate, does not supply an appropriate means of financing beneficial local services that increase the value of real property or that save landlords and tenants out-of-pocket expense. Nor does it rule out special taxation of the site value of land. These particular applications of the property tax, however, find their justification on other grounds than that of ability to pay.

J.R. HICKS, U.K. HICKS, C.E.V. LESER

The Inevitability of Rates

THE property tax, as exemplified in the preceding selections, receives harsh treatment from most critics. Why, then, do we continue to tolerate it? Some of the reasons why the British retain local rates, similar to our property taxes, are indicated in this recent work by British authors: *

English local authorities have always depended on rates as their main local source of revenue; but that is of course no reason why they should continue to do so in the future. The rating system, we shall be showing, is at present in a very sorry mess; and it is not going to be an easy matter to put it straight. Why then, some of our readers will probably object, must we bother to do so? Even at the best rates are far from being an ideal tax; if they have now got into such confusion, surely we have an excellent opportunity for getting rid of them and substituting something better. There are many people who take this view; and we are well aware that in the following pages we are going to provide them with ammunition for their attack on the rating system. Our own conclusion however is different; we believe that the rating system has to be preserved, and therefore ought to be reformed, however arduous a matter it may be to reform it. But since the arguments against rates are becoming familiar, and the arguments in favour of rates are much less familiar, it does seem desirable to set out the case here, even though the discussion must lead us a little away from the problem of valuation, which is our proper scope.

Quite apart from the objections to the present rating system which arise out of the difficulties of valuation, rates have been criticized on two main grounds of principle. On the one hand it is observed that they are a regressive tax (the poor man pays a larger percentage of his income in rates than the rich man does). There is no doubt that this is correct, though the extent of the regressiveness is often exaggerated. On the other hand, they are a tax on housing—a tax, that is, upon a form of expenditure which it is a matter of social policy to encourage, not to discourage like expenditure on alcohol or tobacco. In both these ways the

* From J. R. Hicks, U. K. Hicks, and C. E. V. Leser, *The Problem of Valuation for Rating* (London: Cambridge University Press, 1944), pp. 6–11. By permission of The Macmillan Company, New York, publishers.

imposition of rates seems to be contrary to the aims of a progressive social policy.

These are certainly very weighty objections; if rates were a national tax, paid to the central government, instead of a local tax, it is quite conceivable that they would be strong enough to tilt the balance of argument against the rating system. But even this is not certain; it does not follow, for instance, that a tax is a bad tax merely because it is regressive. With the expenses of government on their present scale, it is not possible for governments to raise the whole of their revenue from the wealthy and the middle-class; this is true even in peace-time. There is not enough income in the upper brackets to meet the bill. The working-class has got to pay some taxes. Now it is very largely a matter of convenience whether this working-class share in taxation is paid in the same way as wealthier people pay the bulk of their taxes (by income tax) or whether it is paid in a different way. The test of equity in taxation is satisfied if poorer people pay a suitably lower proportion of their incomes in taxes than richer people do—but this test must be applied to all taxes taken together, not to any particular tax. It may well be more convenient for poorer people to pay the bulk of their taxes in a different form from that in which richer people pay the bulk of their taxes; if this is done, the poor persons' taxes, taken by themselves, will be regressive; but the demands of equity are still satisfied if the total burden of all taxation is properly progressive.[1]

The argument against rates on the score of their being a tax on housing is very probably a stronger argument. But even here it should be noted that the repressive effect on house-building can be offset by housing subsidies. This may seem a cumbrous procedure, but it is not so very irrational. The housing subsidies are only paid to new houses, and new working-class houses; they therefore cost very much less than the rates on all houses bring in.

Thus neither of the arguments against rates is quite as strong as it looks at first sight; nevertheless it may be granted that if the *central* government had raised its revenue in this way, it is likely that rates would have disappeared long ago. The reason why they have not disappeared, and are unlikely to disappear, is that rates are a local tax, not a national tax. In order to be a suitable source of local finance, a tax has got to satisfy some very stringent requirements. There are in fact very few taxes which do satisfy these requirements. They are satisfied by rates, but they are not satisfied by most of the alternatives which have been suggested. It is very doubtful if there is any other possible tax which satisfies the requirements and which could be relied upon to produce a large amount of revenue.

The first requirement of a local tax is that it should be a very stable source of revenue. Very much the greater part of a local authority's expenditure takes the form of rather long-run commitments. Obviously it

[1] It is well known that the British tax-system, as it existed in 1938, was regressive over ranges of family income of less than £250 a year. (Cf. Shirras and Rostas, *The Burden of British Taxation*, and our forthcoming paper, *The Incidence of Local Rates*). This regressive tail has largely disappeared in war-time, and it may be hoped that it will be prevented from reappearing, on anything like its former scale, when the war is over, by the introduction of family allowances.

cannot suspend the service of its debts; but likewise it cannot easily reduce the number of its employees without the most disruptive effect on its whole organization, while the rates of wages and salaries which it pays are largely outside its control. It is therefore very difficult for it to contract its expenditure when its income falls off. If local revenues were subject to violent fluctuations, every downward fluctuation would produce a severe crisis. The central government, if it experiences a contraction in revenue, can run into debt; it is indeed to be hoped that national governments will in the future be more willing than in the past to meet depressions in trade in this way. But this solution is not open to local authorities to any important extent—nor is it desirable that it should be. Local authorities are not sovereign bodies; they have to work under a fixed code of rules. One of the most important of these rules is that which establishes central control of local borrowing. This control could not be abandoned without running the gravest risk of abuses, and at the same time abandoning one of the most important of the economic controls at the disposal of the central government. Now if local authorities were frequently obliged to borrow, not for capital purposes, but in order to meet casual deficiencies in local revenue, either the central control of borrowing must be abandoned, or one of the most important forms of local autonomy must be abandoned. For the central control of borrowing, as it exists at present, is not only a safeguard against abuses (it would be far harder for a local authority to resist unjustifiable demands for increased expenditure, if it could not point to the extra revenue it would have to raise to match that expenditure); it is also a safeguard of local autonomy. The only autonomy which is possible for a subordinate authority is autonomy within a set of rules; as long as revenue is reasonably stable, the control of borrowing provides a very workable rule on the financial side. So long as the local authority does not run into debt, it can on the whole spend what it likes. But if it were liable to run into debt purely because of a depression in trade, every trade depression would result in a suspension of local autonomy. The local authority would be unable to spend anything without central sanction.

Rates are a very stable source of revenue. At least in peace-time, the land and buildings in an area can be relied upon to be there; they are unlikely to be much diminished in quantity, though they may be increased. So long as they are valued according to their normal value, temporary fluctuations being discarded, their rateable value is affected to a minimum extent by fluctuations in trade. It may indeed be argued that the practices we shall be analysing have made rateable values too stable—too conventional; but no reform of valuations ought to go so far as to remove this precious characteristic of general stability.

There are, of course, other taxes whose yield is fairly stable; but they are not the progressive taxes (income tax and death duties, for instance); for profits are exceedingly sensitive to fluctuations in trade, so that taxes which fall largely on profits are exceedingly liable to have a fluctuating yield. The other stable taxes are the consumption taxes; thus on this ground alone they would be suitable enough as sources of local finance,

though less suitable than rates. The main objection to consumption taxes as sources of local finance is the ease of evading them by making one's purchases in a neighbouring district where rates of tax are lower. Even in the United States, where such evasion is more difficult because of the greater dispersion of population, petrol taxes have proved a rather unsatisfactory source of state revenue because it is so easy for the population living on the fringes of a highly taxed state to fill their tanks by preference on the other side of the border.[2] It can hardly be doubted that in England the use of any consumption tax for local purposes would drive trade out of the large towns into the surrounding country—thus leaving the finances of those towns in an even more serious condition than they are often in at present. For while divergences in local rate poundages have something of the same tendency (people move out to escape the high rates), it would be far easier to buy one's petrol or cigarettes in the cheaper area, or even to do all one's shopping there, than it is at present to change one's residence.

The stability of rateable value as a source of revenue is probably the decisive argument in favour of rates; for it follows from this that the rating system cannot be abandoned without a radical change—for the worse—in the political character of English local government. But there is another argument which tells the same way, and which should not be overlooked.

The attempt which has been made in modern England to organize social services through the local authorities may be politically admirable, but it has led, in the economic sphere, to very paradoxical results. The purposes of the social services is to secure a minimum standard of amenities for all citizens; all those who cannot provide such amenities for themselves, out of their own incomes, should have them provided by the public authority. Now if the public authority in question is the local authority (as on political and administrative grounds there are strong reasons for concluding that it should be) then the greatest burden is laid upon those local authorities which have the largest proportion of poor people within their districts; and this must mean, whatever system of taxation is used, that the greatest burden falls upon the poorest authorities. The resulting inequity has been realized, and an attempt to meet it has been made by the giving of grants. But however generous the grants may be (there can be no doubt that in fact the grants received by many poor authorities are not nearly generous enough), it is impossible by grants to overcome the whole difficulty. If the grants given were sufficiently generous, they might enable the poor authority to reach an appropriate minimum level of expenditure without imposing unduly heavy taxation (we are far from reaching this point in practice). Yet even so, the poor au-

[2] American states and municipalities are a fascinating fiscal laboratory, but it is doubtful if we in England have much to learn from them. The tragic economic history of America during the nineteen-thirties is very largely a lesson in the evils of allowing too much autonomy to subordinate authorities. The final conclusion which an economist might draw from the great American depression and from the failure of the New Deal to cure unemployment is that you cannot allow secondary authorities so much rope unless you also grant them the ultimate attribute of economic sovereignty—separate currencies under their own control.

thority would only be able to go beyond this level of expenditure (as it might have the best of reasons for desiring to do) if it imposed a higher rate of tax than a rich area would need to impose in order to finance a similar expansion. However generous grants become, they cannot give the poor authority the same liberty as the richer authority derives naturally from its greater wealth.

This inequality is bound to exist under any system of local taxation; whatever type of tax is employed, a poor town will have to pinch more than a rich town if it is to squeeze out an extra five shillings per head of its inhabitants. Nevertheless it is important to notice that some sorts of tax are much less hampering to the poor area than others are.

The least hampering type of tax is the rather regressive tax to which everyone contributes, the sort of tax which we have found to be desirable as a *local* tax on other grounds. The most hampering variety is a progressive tax, such as income tax, from which everyone whose income falls below a certain level is exempted, or largely exempted. The wealthy authority, which has plenty of freedom anyway, would find its resources improved by the introduction of a local income tax in place of rates; for the advantages which it would gain from the ability to make larger inroads into the incomes of its wealthier citizens would outweigh the loss from the exemption of the poorest. Thus when the matter is looked at from the point of view of a wealthy authority, the local income tax seems to be a most desirable reform; it would increase the resources at the disposal of the authority, and enable it to lighten the burden on its poorer citizens. But from the point of view of a poor authority, the position is very different. It would be easy to find local authorities in England and Wales whose wealthy citizens are a mere handful, and whose poor citizens, who do contribute to rates, but who would contribute very little to a local income tax, are the immense majority. Such an authority would lose enormously by the introduction of the more progressive tax; and although the direct loss might be made up by larger grants, the independence of the authority would be seriously undermined. At present, if its citizens decide that there is some amenity which they desire badly enough for them to be willing to meet its cost out of their limited incomes, then they can have it, each of them bearing his share in the cost. But with a local income tax, the greater part of the cost would have to be borne by the few large or moderately large incomes, and in a poor district these might not amount to enough in total for the requisite revenue to be obtainable from them. Even if the revenue was obtainable on paper, it would usually be obtainable only by imposing a high rate of tax—and a high rate of income tax would be vastly more effective than high rates in driving people out of the district. High rates rarely absorb more than a small fraction of the rate-payer's income; but a local authority which imposes a high rate of income tax would find that anyone with an income worth taxing would avoid it like the plague. With a local income tax, or any other sharply progressive local tax, poor areas would be simply unable to get any special amenity they might happen to want, unless they could persuade the central government to meet the bill, or unless they could finance it by cut-

ting their expenditure on other services.[3]

These are the essential arguments in favour of rates as a basis for local taxation; it will perhaps be granted that they are cogent arguments. To use local government—really independent local government—as a vehicle for the execution of a social policy that is national in scope, is an extraordinarily difficult thing to do; but it can be done, and it is certainly well worth doing. Yet it seems unlikely that there is any basis other than a tax of the type of rates on which it can be done.

Enough has perhaps been said to show why the total supersession of rates by some other form of tax is unlikely and certainly undesirable. And that is all that has to be shown for present purposes. If rates are to remain, they deserve to be reformed; it seems clear that they will remain important enough to deserve reform, however hard a matter it may be to reform them.

If indeed all that is proposed is a substitution of some other form of tax for a part of rate revenue, then the foregoing arguments are somewhat less conclusive.[4] The argument about stability loses some, but certainly not all, its force; the argument about the poor authority is certainly less telling. Nevertheless, it should be realized that there are great advantages in raising local revenue from a single tax of determinable type, and these advantages should not be lightly abandoned. If, for example, a local authority had the choice whether to raise the bulk of its revenue from tax A, which fell mainly on the rich, or tax B, which fell mainly on the poor, a very disagreeable element of division would be introduced into local politics. One does not only think of the poor district, containing a few wealthy landowners, which might be tempted to indulge in a little social revolution of its own by taxing the landowners out of existence. One also thinks of the middle-class area, containing a small number of poor people, which is

[3] A practical illustration of this defect of a local income tax is to be found in the experience of Sweden. In 1920 a progressive local income tax was introduced. After twenty years' experience it was found that it had mainly been used by the wealthy authorities, who had little need for further revenue. A commission on local taxation which reported in 1942 recommended that the tax should be discontinued and replaced by a grant in aid, mainly on the ground that the progressive tax intensified local disparities in resources. Cf. *Omläggning av den Kommunala Beskattningen* (1924), pp. 243 ff.

[4] There is another argument against a local income tax, what we might call the Treasury argument, which remains valid if the income tax is used for any considerable part of local revenue. It could hardly not happen that the rates of local income tax would differ considerably in different localities; but these differences would create a problem of war finance similar to that which has perplexed the governments of federations such as Australia. Income tax (all income tax including surtax) cannot rise to a rate of more than 20*s* in the £; otherwise it is better to live on one's capital than to have an income, so the result is wholesale evasion. Now if local authorities were charging income taxes at rates varying between 1*s*. and 4*s*. in the £, this would mean that the central government would be unable (in an emergency) to raise its income taxes to more than 16*s*. in the £ on any incomes; so that millionaires living in the areas with the lower local tax would pay much less than millionaires can be made to pay under present arrangements. Judging by the Australian example, it seems probable that the central government would insist on withdrawing the power of taxing incomes during the emergency from local hands; but if local government had once come to depend upon that power, the effects of the withdrawal on local autonomy might again be very serious.

compelled by government regulation (of which its councillors disapprove) to do something for these people, and which may be tempted to express its disapproval by arranging that as much as possible of the cost is borne by the poor people themselves. The economic conflict between classes is bound to cause trouble in a society such as ours; but it will cause far less disunity if it is played out on the national stage, where it is less complicated by personalities than it tends to be in local politics.

It remains possible that some way could be found for enabling a local authority to raise some fixed part of its revenue from some other tax than rates; but it is hard to see that this arrangement would differ substantially from the system of grants which is at present in existence.

15

ALBERT W. NOONAN*

Improvements in Personal Property Tax Administration

There are three basic duties to be performed in the assessment of personal property. First, the administrator, whether a local or a state official, must discover the existence of taxable property; second, he must find out who owns it or who is liable for any tax levied by reason of its existence; and, third, he must determine how much the property is worth. The discharge of this threefold duty is called the assessment process. There are at least five requisites to its successful discharge. First, the organization created for the task must be designed in accordance with sound principles of administrative procedure, because the task is essentially, if not exclusively, administrative in character. Second, the organization must be staffed with a sufficient number of competent persons, working under conditions that insure a high morale. Third, this personnel must have available to it the equipment which is necessary for the proper utilization of their skills. Fourth, duties imposed on the organization must be reasonable and accompanied with adequate legal power to discharge them fully. Fifth, the organization must be using the most effective techniques that have been discovered and must be constantly engaged in the search for new and better ones.

I do not believe I am telling any secret when I say that, so far as personal property is concerned, there is no jurisdiction to which I could point which possesses all five of the requisites which I have just named. As a matter of fact, only a few have even one or two of them. The con-

* *Property Taxes,* Chap. 16. Reprinted by permission of the Tax Institute, New York.

clusion is inescapable that efficient personal property tax administration simply doesn't exist. Likewise, it is the opinion of most competent observers that it never will.

At this point, I suppose I should follow the usual practice and recite some statistics, incidents and items that would illustrate how bad personal property tax administration really is. However, I am not going to do so. It would be a mere waste of time. I daresay that every bit of evidence I could submit on this score could be matched or exceeded by nearly every person in this audience, either from his own study or from personal experience. I believe this paper will have more value if we skip the evidence and, as a lawyer might put it, agree to the stipulation that personal property tax administration is pretty sour. So what?

Before we proceed to drop the personal property tax into the ash can, there are a few things for us to think about. In the first place, the tax does produce revenue on which many jurisdictions still depend for support.

* * * *

Here the author proceeds to show that the personal property tax produces about 16 per cent of the very substantial revenues derived from the general property tax as a whole. Moreover, replacement sources for the personal property tax would not be free from difficulties.

Possibility of Improved Administration

Thus, insofar as the improvement of the situation is concerned, two distinct avenues of solution suggest themselves. The first is positive and the second is negative. Both are being tried, but only the second appears to be promising.

The positive approach encompasses all the effort being made to improve the quality of the administration of present personal property tax laws by local assessors. The negative approach will include all the effort to diminish the legal personal property tax base or to transfer the assessment to a state agency.

Let us first take a look at what is happening by way of improvement of local administrative practice—either actual or attempted. At the outset, I mentioned the five requisites to good administration, namely, a well-conceived plan of organization, skilled personnel in sufficient number, adequate tools and equipment, responsibilities within reason attended with legal authority sufficient for their expeditious discharge and the application of efficient techniques. If we adopt these criteria as yardsticks, we are forced to admit that recent improvements in personal property tax administration are characterized more by hope than reality. Certainly there is no lack of viewing with alarm, coupled with sound and strong recommendations by state tax commissions, tax study commissions, associations of citizens, association of public officials, writers and others. It is probably within reason to believe that there are at least 100 strong recommendations for each progressive step actually taken.

Cooperation of State Tax Commissions

When we examine those changes in organization which were made in the interest of better local administration, one development stands out quite prominently. I refer now to the

policy of close cooperation with and practical assistance to local assessors by state tax commissions. Until a few years ago most state tax commissions and local assessors seemed to be about as friendly as a couple of Kilkenny cats. Supervision duties of the central agencies were characterized by the big stick of the overlord rather than helpful advice from the wise counsellor. In a large number of states—and this number increases each year—this policy is becoming as obsolete as the kerosene lamp. In the progress of this metamorphosis, the Wisconsin plan of supervision enjoys considerable popularity as a model. As most of you know, the state of Wisconsin is divided into 10 supervisorial districts.[1] In each district there is a permanent office in charge of a supervisor of assessments. Each supervisor is an employee of the state government and is appointed by and responsible to the state tax commissioner. They have two major functions. First, to secure the data which form the bases for county and state equalization; and second, to confer with, advise, assist and supervise local assessors to the end that the original assessments made by local assessors will be as equitable as possible. As should be expected, the assessment of real estate occupies the largest portion of their time, but they have also been extremely useful in improving the assessment of personal property. Last year both Maine and Arkansas established supervision organizations that greatly resemble the Wisconsin idea. Other modifications of it will be found in Massachusetts, Colorado, Illinois, New York, California, Washington and Mississippi. A few tax commissions have found it possible to prepare manuals for the guidance of local assessors. An excellent job in this respect has been done by the Illinois Tax Commission, which has published and distributed a personal property manual which is quite comprehensive and extremely instructive. If all tax commissions could install an adequate supervisory organization, prepare and distribute instructive manuals, and then supplement both with periodic training programs for local assessors, considerable improvement in personal property administration should be the result—although, because of the presence of other factors, it is certain that even then completely satisfactory administration would hardly be achieved.

Reorganization of Assessment Offices

Reorganization in local assessment offices for the purpose of improving the quality of personal property assessments have been extremely rare. Such as did take place were part of a general plan to change the entire office from a geographical to a functional pattern. The Detroit office made this shift about two years ago and the new plan in Philadelphia specifically divides the personnel into two groups—one for personal property, the other for real estate. These are the only ones that come to mind which seem worthy of notice, but it should be pointed out that the membership of the National Association of Assessing Officers is on record in favor of the functional plan of office organization.[2] This type of organization is relatively common in

[1] Under a reorganization plan, which became effective on April 1, 1940, the number of districts was reduced from ten to four. The entire supervisory staff was reduced from 33 persons to 20.

[2] National Association of Assessing Officers, *Assessment Principles* (1939), p. 30.

larger jurisdictions where the office is in charge of one person; but where a board is in charge, work is usually apportioned on a geographical basis. You can add this to the other arguments against the board plan.

Personnel

Neither has there been any substantial progress along the personnel front. Of course, it is true that a number of assessment jurisdictions select subordinate personnel under civil service systems. Such jurisdictions are almost exclusively agencies of city governments, although there are some county assessment offices where this is also the case.

About the only places where the heads of assessment offices are selected on the basis of merit are in those cities using the council-manager plan. With a few exceptions, the assessors in other jurisdictions are either elected by popular vote or appointed by some official or agency restricted only by the probable political consequences of the appointment. I don't want you to misunderstand me. I don't mean that there are no competent assessors in these two latter groups, simply because they are elected to office or did not have to have their qualifications tested before appointment. On the contrary, this group includes many of the outstanding leaders in the field. A notable example is John A. Zangerle, who has been elected and re-elected in Cuyahoga County, Ohio for the past 25 years.

The condition I have just described has remained about the same for the past few years. The only real progress is in the field of thought, and I sincerely believe that there is a constantly increasing recognition of the need for trained and competent personnel. Not only is this true of the public in general, but likewise among the more progressive assessors. The NAAO Committee on Principles of Assessment Practice has flatly recommended that "the assessor should be appointed from among candidates certified as to fitness by a competent and impartial agency." [3]

Equipment

Adequate equipment is not the problem in the assessment of personal property that it is in real estate. To do a good job in the latter field, it is absolutely vital to be well supplied with accurate maps, property record cards, building classification and cost schedules, etc. The equipment necessary for personal property would be the regular list of ordinary office furniture and supplies, plus proper forms for recording essential information and space for filing it. However, when the volume of work is large, the use of mechanical addressing equipment is almost indispensable if extensive use of personnel is to be avoided. I believe most offices are fairly well supplied with the ordinary requirements, but there still are thousands of districts which have about one desk and filing cabinet. Frequently, the only records consist of the returns filed by taxpayers.

Authority Commensurate with Responsibilities

As we all know, assessors have always been handicapped because their authority was not commensurate with their responsibilities. As an example, many states require the assessment of bank deposits to the depositors, but then proceed to withhold from the assessor the authority to demand a list of the depositors from

[3] *Ibid.*, p. 19.

the bank, which is the best and most obvious source of information. I recall a few years ago that a bill sponsored by the West Virginia County Assessors' Association sought this privilege, but it was promptly killed when the banking interests protested that if lists of depositors were made available to the assessors, the assessment of deposits might follow, and if that took place the deposits would promptly be removed and redeposited in banks in other states. If the legislature believed this, it should not have stopped at killing the bill making the lists of depositors available; it should also have repealed the act making the deposits taxable—instead of being content to leave the assessors hanging on the end of a limb. I regret to state that the legislative policy mentioned above has changed but little in recent years. There was one measure adopted in Oklahoma, however, that would be a good model for other states. In the new intangibles act adopted last year, there is a provision that denies any judicial remedy to the owner of any taxable intangibles until he submits evidence that they have been assessed and the taxes paid. A few other states have somewhat similar provisions, but with this important difference: Oklahoma puts the burden of proving the assessment and tax payment on the taxpayer, while in the other states it is usually the duty of the defendant to disprove it.

Other Considerations

Probably something should also be said about the Costigan Amendment, although this measure is nearly five years old. It was intended to make federal income tax returns available to local assessors, where they would be especially valuable in the assessment of intangibles but also useful in checking assessments of such tangibles as would be included in business inventories. However, through an interpretation placed on the act by the Treasury Department, accessibility is extremely restricted. Where the federal income tax returns were made available, the assessment of intangibles rose sharply.

Even in the field of technical procedure it is difficult to find any substantial improvements. Perhaps some of these are worthy of mention. Before doing so, it should be emphasized that one of the most important obstacles to effective personal property assessment is the fact that personal property has so many forms and uses. A technique which may be extremely effective for one type may be quite useless so far as other types are concerned. This means that it is almost necessary to have a special procedure for each type of personal property, whether tangible or intangible.

In those places where intangibles are still required to be assessed by the local assessor, there are two noticeable forms of improvements. The first is more extensive use of public records. This includes the use of federal income tax returns, state income tax returns, the corporation statements filed with the Securities and Exchange Commission, and those filed with state agencies. Progressive assessors have long since gotten over the naive belief that returns of taxpayers can be relied upon without checking every available source of information.

Another development not without significance is the growing spirit of cooperation among local assessors on the matter of exchanging information. This is true on both an

intra- and interstate basis. Several states now require intrastate cooperation as a matter of law, but we also have records of numerous examples of interstate cooperation which is absolutely voluntary. It should be added that this is common practice among members of the Association which I represent and is something that is encouraged as much as possible. This exchange of information is useful in the assessment of tangible as well as intangible property. Where they can get their hands on them, assessors are also making much use of so-called confidential reports filed by individuals, firms or corporations when seeking credits.

Administrative Problems in Assessing Tangibles

In many respects, tangible personal property is less adapted to standardized treatment than are intangibles. Consider the variety of types of tangible personal property: household furniture, business furniture and fixtures, motor vehicles, livestock, merchandise stock, goods in process, raw material, farm machinery, factory machinery, tools, equipment, etc., to mention only the most important classifications. And every one of these classifications could be subclassified almost without end. It is apparent that it is almost necessary to have a specially trained man in the appraisal of each class, which you will readily admit is impossible except in the largest assessment jurisdictions.

I have mentioned the personal property manual prepared by the Illinois Tax Commission. A few other states have also undertaken this task, but the effort doesn't display the same degree of thoroughness. Yet, they probably have been the means of some improvement.

The problem of assessing the stock of merchants is partially being solved by adopting the average inventory instead of the inventory as of the assessment date. Eighteen states now follow this method and it is being advocated in many of the others. Utah, however, repealed such a law in 1939, because, according to one of the assessors, it was resulting in more effective assessments. There is also a trend toward the establishment of a uniform assessment date throughout the nation. January 1 is now used by 19 states and is being recommended in others. Connecticut requires that watercraft be registered with the local assessor instead of the clerk, and many of the states still levying property taxes on motor vehicles require registration lists to be furnished local assessors. Some go even further. In a few cases, the assessor handles the distribution of state license plates and in others the owner must present his property tax bill before he can secure his plates.

Household furnishings were never satisfactorily assessed for two reasons: first, because assessors are reluctant to enter homes for the purpose and, second, because the variety almost defies any attempt accurately to appraise it. One short cut which seems to meet with increasing approval is to value the furnishings at a percentage of the value of the house which contains them. On the other hand, the trend is definitely in the direction of either exempting household furnishings outright or else increasing the amount of the exemption so as to exclude from assessment all except that contained in large and expensive dwellings.

Other improvements which might

be mentioned include use of the radio in securing better response from taxpayers in the filing of returns, the employment of specialists in personal property divisions, greater use of the field canvass, and the development and maintenance of better record-keeping systems. However, these improvements are definitely sporadic and for reasons already indicated have probably contributed only a little to general improvement of personal property tax administration.

Trend to Exemption of Intangibles

So much for the so-called positive improvements. It is the improvements of the negative variety that have commanded the most attention and produced the most effective results in recent years. So far as intangibles are concerned, there is a definite and strong trend either to exempt them entirely or reduce the tax and turn administration over to a state agency, usually the state tax commission. Within the past two years, North Carolina, Georgia and Michigan were added to the list of states in the latter category, which left only nine states still maintaining the fiction that intangibles are being adequately assessed under the general property tax. Nevada will vote next year on a constitutional amendment to prohibit any property taxes on intangibles. In 1938 the Arizona Supreme Court held the assessment of intangibles was illegal for the very strange reason that they had not been previously assessed and that failure to assess over a long period had nullified the act creating the tax liability. Theoretically, state administration is much better than local administration of intangibles; and in the states where the shift has been made the evidence is fairly substantial that improvement did take place,[4] but not to the degree which most advocates predicted.

At the present time there is a great amount of personal property, tangible and intangible, assessed by state agencies, under many different schemes. Where changes do occur, the trend seems to be still in that direction. Last year Arizona and Arkansas transferred to the state tax agency the responsibility for the assessment of all property of pipe line companies, while Louisiana decided to have the state tax commission assess the property of chain stores.

Delaware finally repealed all laws imposing taxes on personal property, but this was only legal recognition of a condition that had existed for years. In Cook County (Chicago), the assessor not only adopted but publicly announced his adoption of an extra-legal classified personal property tax scheme and it seems to have met with pretty general public approval. No sanction for it can be found in any Illinois law, but he justified it on the basis of existing tax competition in other states. Another important part of his administrative policy is the total exemption of all personal property below $400 in value, justified by the assessor on the ground that the expense of collection of small accounts often exceeds the tax collected.

Summary

Time does not permit me to describe in detail the changes mentioned above. However, I think I have given you a brief outline of the

[4] *The State as an Assessment District.* 4th Progress Report of the Committee on Assessment Organization and Personnel, National Association of Assessing Officers, p. 46.

type of changes which indicate the direction in which the work of improvement is moving. Obviously, the strongest movements are in the direction of the abolition of personal property taxes in the present form or transferring the assessment of intangibles and certain types of tangibles to the state tax agencies. They are probably the strongest because they are the most logical, and while logic doesn't seem to count for much in framing tax policy, it is a pressure that is always present.

In the other direction are the improvements in local assessment offices. These attempts are inclined to be a little half-hearted, because most assessors are of the opinion—shared by many authorities—that they are charged with duties which cannot be performed no matter how hard they try. They get a bit tired from always being obliged to swim upstream in a current which moves faster than they can swim. In countless local assessment offices serious effort to assess personal property, especially intangibles, was discontinued years ago and there is not much hope that it will be revived.

Two states, New York and Delaware, have already completely abandoned taxes on personal property, and it will occasion no great surprise when other states proceed to do the same. But so long as something like 750 million dollars are involved, this change is not going to take place overnight.

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NATIONAL ASSOCIATION OF ASSESSING OFFICERS

Assessment Organization and Personnel

SOME of the recommendations for improving property tax administration, proposed by a committee of assessors, follow: *

II. *Primary Local Assessment Districts*

Property tax assessment administration in every part of the country operates within the framework of an organization prescribed in considerable detail by the state legislature. But the administration has not been vested in a state agency—except in limited degree—even where a state property tax is levied. Instead, it has been largely decentralized in the

* Reprinted by permission from *Assessment Organization and Personnel* (Chicago: National Association of Assessing Officers, 1941), pp. 4–8; 13–16; 24–29.

counties or other political subdivisions of the state. Each of these political subdivisions typically selects its own assessor, pays the cost of the assessment function out of its own tax revenues, and, through its own legislative body and perhaps its chief executive, exercises considerable control over the whole assessment process. In this typical situation, the political subdivisions constitute assessment districts, although there are some states in which each such subdivision is broken up into still smaller administrative areas for assessment purposes.

Assessment districts on the local level are of two types. Primary districts are contiguous and together occupy the whole area of the state. Their assessors prepare the rolls on which the state and county levies (if any) are extended. Overlapping assessment districts, on the other hand, are non-contiguous governmental units which are authorized to establish assessing agencies and to list and appraise property for their own tax purposes despite the fact that the same property has been listed and appraised by a primary district. Although every state has primary assessment districts, less than half of them have overlapping districts.

There are approximately 26,300 primary assessment districts in the United States. Counties or their equivalent (including one consolidated county and city in each of three states and one or more cities which are not within the limits of any county or counties in Maryland and Virginia) are the only primary districts in 26 states. Townships or their equivalent (including towns and cities in New England and municipalities which are not within the limits of any township or townships in 7 other states) are the only primary districts in 15 states. In the remaining 7 states, the county pattern of assessment districts is found in some areas and the township-municipal pattern elsewhere. The number of districts in a single state varies from 3 in Delaware to 2587 in Minnesota.

The populations of primary assessment districts in the United States vary from about a half dozen to nearly seven and a half millions, while their assessed valuations vary from $25,000 to over $16,500,000,000. Over 23,000 primary districts—92 per cent of the total number—have populations of less than 10,000. This tremendous number of small districts presents one of the major problems of assessment organization. Such districts have an assessment task which is inadequate for the development of specialized skills and the employment of a full-time minimum staff of one assessor and at least one assistant; they lack resources for the support of an assessment department; and they generally suffer from a relatively poor assessment performed at a relatively high cost per dollar of assessed valuation.

The committee makes the following recommendations:

1. The assessment district should ordinarily be coterminous with the political subdivision performing the assessment function.

2. The political subdivision performing this function should be one which engages in other important governmental activities and which finances itself in large measure out of property tax receipts.

3. The political subdivision serving as an assessment district should have sufficient resources to afford adequate assessment machinery, and

should provide an assessment task large enough to realize the economies of large-scale operations and to warrant the employment of one full-time assessor and at least one full-time assistant.

4. The assessment district should not be so large that the flexibility required to adapt the assessment process to special cases is lost.

5. Where existing assessment districts do not meet these standards, the state should be redistricted by one or more of the following means:

a. Two or more small governmental units which perform assessment functions may cooperate to form a single assessment district.

b. Two or more small governmental units which perform assessment functions may be consolidated to form a single governmental unit.

c. The assessment function may be transferred to an existing governmental unit whose area includes that of two or more of the units now performing the function.

d. The assessment function may be transferred from townships and small municipalities to their counties while large municipalities are separated from their counties.

e. An exceptionally large assessment district may decentralize its operations by establishing branch offices in charge of deputies to whom a large measure of authority and responsibility has been delegated by the assessor.

III. *Overlapping Local Assessment Districts*

Overlapping local assessment districts are found in 22 states and number around 6300. Some of these are required to assess their own property taxes, while others are permitted but not required to do so. Probably between three and four thousand actually undertake the task. Generally speaking, the assessors of these districts have the authority to list and appraise all *tangible* property which is assessable by the agencies of primary districts.

There are several reasons for the existence of overlapping assessment districts, chief among which are: (1) the failure of assessors of primary districts to appraise property at its full value, and the consequent inability of overlapping districts to raise as much in taxes or incur as much indebtedness under existing laws as they can when doing their own assessing; (2) the failure of primary districts to do a good enough assessment job to satisfy the residents of overlapping districts; (3) the belief that the assessment of property taxes is a legitimate exercise of home-rule powers. Although one or another of these reasons may justify the existence of many overlapping assessment districts, it is generally agreed that such districts are expensive, annoying to taxpayers, and frequently subversive of good assessment in the primary districts and of proper equalization of taxes on state-assessed and locally assessed properties.

* * * *

VI. *Selection, Tenure, and Compensation of Assessors*

The internal organization of a local assessment office is like a skeleton; but it takes more than bones to make a living organism and more than an organization to make a governmental agency. The organization must be properly staffed with an assessor and, in all assessment districts of respectable size, with one or more subordinates. The importance of this staffing process can hardly be exaggerated.

It has been widely assumed in the past that most anyone is good enough to fill the office of assessor. But the circumstances which gave rise to this assumption are fast disappearing, and the public is gradually beginning to realize that competent assessors have an unusual combination of talents. It must be apparent, however, that persons who have the desired qualifications cannot be attracted into the assessor's office unless they are offered good salaries and a relatively secure tenure. And, of course, with higher rewards of office, there is certain to be a larger number of potential candidates, and the machinery for choosing one of them to serve as the assessor becomes increasingly important.

As a rule, almost any member of the local electorate is legally eligible for the office of assessor. Thus United States citizenship, an age of at least 21 years, a certain period of residence in the locality and the state, and, less universally, the ability to read and write are the principal statutory qualifications. Whether someone meeting these requirements can obtain the position depends upon his appeal to the voters in about nine out of ten assessment districts and to the city council, mayor, manager, or some other appointing agency in the tenth district. There is a formal examination of candidates only in the 120 Kentucky counties, where they must be tested by the Commissioner of Revenue before standing for election, and in about a dozen cities whose civil service commissions have jurisdiction over the assessor as well as over his subordinates.

Approximately 49 per cent of the primary assessment districts of the United States select their assessors for two-year terms, 27.5 per cent for four-year terms, 18 per cent for one-year terms, and the remaining 5.5 per cent for terms of three, five, six, or an indefinite number of years. Although similar data have not been collected for overlapping districts, it is considered unlikely that they would greatly alter this distribution.

There are provisions for removal of assessors by the electorate, by the courts, or by some state or local officer or board in all states, but they are seldom resorted to except in jurisdictions where the assessor holds office "at the pleasure" of the appointing officer or agency. This infrequency of removal, coupled with frequent reelection or reappointment of incumbents, produces a low rate of turnover. A rough estimate fixes the average rate of turnover at 12 per cent, indicating that the typical assessor holds office for more than eight successive years.

A majority of township and village assessors receive per diems ranging from \$2 to \$10. Cities and counties, instead of per diems, usually pay annual salaries ranging from \$50 to \$60 in places where the work requires only two or three weeks a year up to ten or fifteen thousand dollars in our largest assessment districts. In a few states, assessors are paid a commission on the number of dollars of assessed valuation, the number of parcels of real estate and lists of personalty assessed, or similar bases.

The state legislature usually fixes the exact compensation of county assessors and the maximum compensation of township assessors. Municipal assessment districts, on the other hand, are very often allowed to determine the compensation of their assessors by local ordinance. Salaries are ordinarily paid out of taxes levied by the assessment district itself,

although payment of township assessors' salaries by county governments and of a portion of county assessors' salaries by state governments is not uncommon.

Retirement and disability benefits, which may be thought of as deferred compensation, are available to assessors in a half dozen states if the governing bodies of their assessment districts choose to join a state-wide pension system or to conform to a state enabling act.

The committee makes the following recommendations:

1. Statutory qualifications for the office of assessor may properly include maturity, literacy, citizenship, and freedom from conviction of felonies, but should not include prior residence within the assessment district or property ownership.

2. The state tax department or a state or local personnel agency should be empowered to establish further qualifications for assessors, to examine candidates, and to certify their fitness for office.

3. As a general rule, assessors should be appointed to office.

4. Appointments to the office of assessor should ordinarily be made by the chief executive or executive board of the assessment district.

5. An appointed assessor should generally serve for an indefinite term of office and an elected assessor for a term of not less than four nor more than eight years, without restrictions as to service of successive terms.

6. Assessors should be removable for good cause, by the appointing agency if appointed, by the electorate and by the courts or the head of the state tax department if elected.

7. The assessor's compensation should take the form of a fixed annual salary, not fees, commissions, or per diem allowances.

8. When the compensation of the local assessor is paid entirely by the local assessment district, it should ordinarily be fixed by the legislative body of the district.

9. The compensation of many assessors should be increased by means of (a) larger appropriations by existing assessment districts, (b) state aid to existing districts, or (c) the consolidation of districts of uneconomic size.

10. The salary of an assessor serving a definite term of office should be altered during his term only as part of blanket changes in the compensation of all officers and employees of the assessment district.

11. Membership in retirement and disability systems applicable to the general employees of assessment districts should be optional for assessors serving definite terms of office or at the pleasure of the appointing agency and mandatory for those serving indefinite terms with protected tenure.

* * * *

X. *Equalization Agencies*

The functions of review and equalization are seldom distinguished by the general public and are often intermingled in practice. This intermingling is not undesirable, but the confusion must be removed if the assessment institutions of certain states which assign the two functions to separate agencies are to be understood and if the techniques which are appropriate to equalization and not to review are to be adopted.

Equalization is the process by which an agency increases or decreases by a uniform percentage the assessed valuation of all property, or

all property of a particular class, within a single tax or assessment district. It is intended to serve various purposes: (1) to bring the average assessment ratios of two or more tax or assessment districts to a common level before the imposition of a tax intended to bear uniformly upon all districts; (2) to bring such average ratios to a common level before the distribution of funds to tax districts according to a formula involving assessed valuations; (3) to bring the average assessment ratios for state-assessed property and locally assessed property to a common level when both are subject to the same or related tax rates; (4) to make tax levy and debt limitations based on assessed valuations effective by equalizing the average assessment ratio and the legal ratio; and (5) to bring the average assessment ratios for various classes of property to a common level before imposition of a tax intended to bear uniformly on all classes.

Equalization powers are possessed by many administrative review agencies but are infrequently exercised if the agency has jurisdiction over only one local assessment district. The equalization and review agencies with jurisdiction over more than one local assessment district include 19 state, 728 county, and 24 city agencies. There are, in addition, 20 state agencies and 309 county agencies which have equalization powers but may not review individual assessments.

County equalization agencies having jurisdiction over more than one assessment district may alter assessed valuations by assessment districts and usually by classes of property. All state equalization agencies may alter assessed valuations by counties; 26 may alter them by classes of property; and 24 by minor tax districts.

An equalization board, unlike a review board, is not bound by the federal constitution to give notice of orders increasing assessed valuations or to afford taxpayers or their representatives hearings on request. Statutory rights of appeal exist in a minority of states, and court appeals are usually confined to questions of law.

The procedure of equalization involves two steps. First, the average assessment ratio must be found for a group of properties. Among the more competent agencies this is done by a sampling process or by a reappraisal of the whole group. The second step is to put this finding into effect. This is sometimes accomplished by changing, or ordering a local official to change, each of the assessments of property subject to the order; but frequently it is done simply by basing calculations as to state tax rates, the apportionment of state funds, etc., on a hypothetical aggregate assessed valuation higher or lower than that on the assessor's books.

Such information as is available indicates a low degree of success in county equalization and far less success than might reasonably be expected in state equalization. The only notable achievements are those of agencies resting their decisions on facts gathered by a full-time staff of qualified, well-paid persons.

The committee makes the following recommendations:

1. The need for local equalization agencies should be removed by the enlargement of local assessment districts, by functionalization and close coordination of the work of deputy assessors, and by an expansion in the activities of state equalization agencies.

2. A state equalization agency

should be maintained in at least those states which impose taxes, share taxes, or make grants-in-aid on the basis of local assessed valuations, or in which some property is state-assessed but is taxed at local rates or at an average of local rates.

3. Members of an equalization agency should be chosen at large by a person or persons representing the whole equalization district and not by representatives of portions of the district.

4. Equalization agencies should be given powers of assessment review unless independent agencies for assessment review and for assessment supervision exist on the same level, in which case the equalization function should be assigned to the supervisory agency.

5. State equalization agencies should be permitted to equalize by minor tax districts and by classes of property as well as by counties.

6. Equalization agencies should be given the option of ordering changes in individual assessed valuations or in tax rates and distribution ratios.

XI. *Assessment Supervision*

Some outside supervision is given to all of the steps in the assessment process—the original assessment, the review of individual assessments, and the equalization of groups of assessed valuations—in almost all states. In saying this, however, we are deliberately using the term "supervision" to embrace activities which might better be described by the words "advice" and "assistance." Even without this expansion of the term, it is vague enough to make a precise enumeration of assessment supervisory agencies a futile undertaking. However, we have more or less arbitrarily directed our attention to some 46 state agencies, 398 county agencies, and perhaps two hundred city agencies which have legal authority to influence appreciably the procedures of agencies directly responsible for the performance of the assessment function.

Supervision by municipal agencies is, or might well be under the law, of a very intimate nature. Not only is the assessor in most cities having a strong mayor or council-manager form of government subject to general supervision by the chief executive, but he is subordinate to the finance director in a good many council-manager cities and to the finance commissioner in most cities which are governed by a commission. In all instances the assessor retains at least a vestige of final authority by signing the assessment roll, but he can become little more than a chief deputy assessor if he serves under an aggressive finance officer who holds, by law or in practice, the power of appointment without showing of merit or of dismissal without showing of cause.

County supervisory agencies are found in several of the states which are divided into township-municipal assessment districts. Where the supervisor has few other duties, as in Indiana and five counties in Kansas, supervision is usually fairly close; elsewhere it is likely to be superficial and largely ineffective.

While we have identified state supervisory agencies in all states except Delaware and Pennsylvania, there are nearly a dozen more states whose supervisory agencies have few powers, and less than a dozen in which an active program of supervision has been instituted. There is little correlation between law and practice in this field. The number of different

supervisory powers available to the state tax departments of South Carolina and South Dakota is great but actual supervision is negligible, while the more modest powers of the Wisconsin department have been exercised with an energy which has won the department much fame.

Most of the activities of state supervisory agencies are of an educational character. Such activities include answering individual inquiries, sponsoring assessment conferences, issuing manuals and other literature, and demonstrating methods through the medium of field agents. Other supervisory activities are investigational or regulatory in nature. Classified as regulatory are the well-nigh universally exercised power to prescribe forms and the less frequently granted and seldom exercised power to issue rules and regulations. Although commonly armed with drastic enforcement measures, such as reassessment orders and proceedings for the removal of assessors from office, state tax authorities have usually preferred to keep the iron fist well concealed within a velvet glove.

The committee makes the following recommendations:

1. The assessor should be under the general supervision of the chief executive or the executive board of the governmental unit which performs the assessment function.

2. Supervision of township and municipal assessors by county agencies should, as a rule, be abandoned and any need which it may be designed to satisfy removed by enlarging local assessment districts or by expanding the supervisory activities of the state tax department.

3. The state tax department, or some similar agency, should supervise local assessors whether or not the state imposes a property tax for its own support.

4. The state tax department should exercise its supervisory powers principally by interpreting the tax law, disseminating useful information concerning assessment methods and property values, and providing technical assistance on difficult aspects of the assessor's task.

5. Drastic enforcement measures, such as issuance of reassessment orders and institution of proceedings for removal from office, should be employed only on petition of the local assessing officer, the board of review, the chief executive of the assessment district, or a substantial body of taxpayers and after careful investigation by the supervisory agency.

6. Ordinarily, the state supervisory staff should be organized functionally where the county serves as the assessment district and geographically elsewhere.

7. Supervisors should be selected only after showing of merit and dismissed only after showing of good cause.

JAMES C. BONBRIGHT

The Valuation of Real Estate

VALUATION for property tax purposes poses many problems both of standard and of application. Some of these difficulties are suggested in the following selected paragraphs from an article by Professor James C. Bonbright: *

Market value versus value to owner.—Several cases have raised the question whether value for tax purposes means market value in the literal sense of realization price with respect to property that is obviously worth much more than this price to its present owner. Sometimes this issue has arisen when the pertinent statute requires the use of "market value" or "fair market value" as the basis of appraisal; for even here it is open to argument either that "market value" means sale price in a *hypothetical market,* or else that the statutory standard is applicable only when the property "has a fair market value." But when "true value" or some similar phrase is used in the law, there is room for the further contention that this value is not necessarily the same thing as market value.

The courts of Wisconsin have been the most outstanding of the strict constructionists in holding that market value, as used in the tax statutes, means realization price. In the City of Oshkosh there was a golf course, owned by a club which had invested $35,000 in developing it and whose members had no intention of selling the property.[1] Had they attempted to dispose of the links, they would have been compelled to sell them as meadow land, since no other purchasers for a golf course existed,—so at least the court assumed, apparently not contemplating the possibility of sale to other golfers. Despite the probability that the property was worth at least $35,000 to the owners, the court held that it should be taxed only at meadow-land value. Had the owners been deprived of the property by a fire insured against, or by a negligent tortfeasor, there is no doubt but that the court would have awarded the "golf course" price. Only then would there have been full compensation for the loss of the property. So, too, the owners, if incorporating, could have issued stock on that basis. But for the purposes of taxation, the court reached a very different result by insistence on the liquidation-price concept of market value. What sum of money, it asked, would be received

[1] State *v.* Petrick, 172 Wis. 82, 178 N.W. 251 (1920).

* Reprinted by permission from "The Valuation of Real Estate for Tax Purposes," *Columbia Law Review,* XXXIV, No. 8 (Dec., 1934), pp. 1397–1438.

if the land were offered for sale by the present owner to others? The Wisconsin statutes, to be sure, offered somewhat more basis for this interpretation than the usual general property tax provisions: "Real property shall be valued . . . at the full value which could ordinarily be obtained therefor at private sale." As the court read this, it pointed specifically to a liquidation price.

The same result was reached in a later Wisconsin case [2] involving the valuation of an office building peculiarly constructed to meet the requirements of its owner, an insurance company, and not readily convertible for use by others. The owner had no intention of selling the building, which had been constructed at a cost of $3,150,000 and would cost $4,000,000 to reproduce. On exactly what basis the assessment attacked, $2,750,000, was cut in half by the lower court does not appear. Said the appellate court: [3]

> The argument that the owner may be considered as standing in the place of a purchaser who, if desiring to buy, would pay its reasonable intrinsic worth, forgets the statutory test, namely: What will it bring if the owner is the seller and somebody else is the buyer? The statute does not contemplate that the owner shall be both seller and buyer.

The logic of the Wisconsin rule, it will be observed, leads to the strange result that the same property will be taxed less in the hands of one who is putting it to the more profitable of two possible uses. Thus, if the building in the insurance case had been built by an independent contractor for temporary use as an office building and eventual sale to an insurance company about to be organized, it would be taxable in his hands at a sum approaching insurance-building value; but as soon as the transfer took place, the valuation would have to be diminished, since the new owner could sell only for office-building purposes.

In marked contrast with the position of the Wisconsin Supreme Court is that of the New York courts in a recent litigation over the tax assessment of the New York Stock Exchange building.[4] The assessors there had valued the building in 1921, over and above the value of the land, at approximately two-thirds of original cost in 1903, which was about one-half of estimated replacement cost. Counsel for the Stock Exchange argued that the assessment should not exceed the value of the bare land, since the building was quite unique

[2] State *v.* Weiher, 177 Wis. 445, 188 N.W. 598 (1922). Here, as in the Petrick decision, the court stated that it was not objecting to reproduction cost as presumptively measuring the market value, in the absence of evidence to the contrary. State *v.* Norsman, 168 Wis. 442, 169 N.W. 429 (1918), which had done just this where the building did have potential purchasers, was approved in both the Petrick and Weiher decisions. Cf. National Lumber & Mfg. Co. *v.* Chehalis County, 86 Wash. 483, 150 Pac. 1164 (1915).

[3] See State *v.* Weiher, 177 Wis. 445, 448; 188 N.W. 598, 599 (1922). A Minnesota decision, State *v.* Russell-Miller Milling Co., 182 Minn. 543, 235 N.W. 22 (1931), purported to follow the Weiher case in the assessment of a mill. However, there was no indication that the mill property possessed any peculiar value to the owner. Presaging an abandonment of the Wisconsin doctrine where the property is of such magnitude as to preclude a ready market the court in State *ex rel.* Flambeau *v.* Windus, 208 Wis. 583, 585, 243 N.W. 216, 217 (1932), said that factors like book value, the price at which the property was listed for sale, and the insurance carried, might be considered in computing "sale value."

[4] People *ex rel.* N.Y. Stock Exchange Bldg. Co. *v.* Cantor, 221 App. Div. 193, 233 N.Y. Supp. 64 (1st Dept. 1927), *aff'd*, 248 N.Y. 533, 162 N.E. 514 (1928).

and would be of no possible use for any other purpose, not even for any other stock or produce exchange. In support of this plea, plaintiff offered to prove by the testimony of real estate experts that, for liquidation purposes, the building was actually a nuisance and would reduce rather than enhance the value of the land. None of these contentions of fact seem to have been disputed by counsel for the city. Yet the Appellate Division and the Court of Appeals (without a reported opinion) upheld the tax assessors in placing a value on the property far in excess of the value of the land alone. In so doing, however, the Appellate Division met the objection that market value, strictly speaking, means sale value, by construing the tax statutes to call for the "full value," and by holding that market value was to be used as a criterion only under circumstances where it faithfully reflected the full, true value. The opinion does not explain what is meant by true or full value. Apparently, however, the terms were used in order to justify an assessment based more closely on the value of the property to its existing owner than on liquidation price.

A similar distinction, made for a similar purpose, may be found in the Connecticut decision involving the valuation of the Underwood Typewriter works in Hartford.[5] Here it appeared that the original cost of the plant was $1,481,000 and that the assessors had appraised the property at $2,432,700, doubtless taking account of the higher construction costs prevailing at the time of the assessment. The lower court had reduced the assessment to $1,700,000, saying that the basis of the tax under the statute was "market value" and that the reduced figure fairly represented that value. But the Supreme Court reversed the lower court and remanded the case for retrial, on the ground that market value was not here the proper test. This holding was made in the face of statutes providing that buildings used for manufacturing purposes should be assessed "at their present true and actual valuation" and that "the present true and just value of any real estate shall be deemed . . . to be the fair market value thereof, and not its value at a forced or auction sale."

Commenting on these provisions Judge Burpee said: [6]

> Ordinarily market value means a price fixed by sales in the way of ordinary business, and is established when other property of the same kind has been bought and sold in so many instances that a value may reasonably be inferred. The term contains the conception of a market, or conditions, in which there may be found a willing seller and a willing and able purchaser.

In the present case, however, continued Judge Burpee, it would have been difficult to get a purchaser at any price, and quite impossible to get one at any price that the owner could fairly be expected to accept. "In fact, at that time there was no market for the property, and it did not have a value which was the fair market value in the proper and approved meaning of the term." [7] He concluded that, since there was no market value properly speaking, and since the legislators certainly could not have intended to exempt such

[5] Underwood Typewriter Co. *v.* City of Hartford, 99 Conn. 329, 122 Atl. 91 (1923).

[6] *Id.* at 334, 122 Atl. at 93. The statutory provisions in question were Conn. Gen. Stat. (1930) Sections 1183, 1197. From the reasoning of Judge Burpee, Judge Beach sharply dissented.

[7] *Id.* at 334, 122 Atl. at 93.

property, its "true and actual value" should form the tax base. But Judge Burpee, like the New York court in the previously mentioned case, failed to add what "true and actual value" means. He did indicate that both actual cost, with corrections for depreciation and for changing price levels, and estimated replacement cost depreciated "have often been resorted to and considered," although neither is necessarily to be taken as an invariable measure of value.[8]

One might infer from these cases that only those courts which set up "real" or "true" value as a test are free to approve an assessment which takes account of the higher value of the property to its existing owner. This is not so, however; for in other states courts have attempted to remain faithful to the market value phrase wile distinguishing it from the price at which the property could actually have been sold. In New Jersey, for example, the statutory criterion of the tax base has been substantially the same as that of Wisconsin; the price that the property "would sell for at a fair and bona fide sale by a private contract."[9] Yet in applying this statute, the courts have conjured up a *hypothetical* sale at which there will be bidders who want property of the very type the taxpayer possesses, even though it is plain that if the property were actually offered for sale no such bidders could be found. A decision of the Court of Errors and Appeals frankly declares this.[10] The taxpayer asked and was granted a substantial abatement on the ground that he had introduced into his residence a number of "features and fancies" that added nothing to its salable value though greatly increasing its cost. But the court took care to add:[11]

> We are not disposed, however, to give much force to the argument that because there are very few actual buyers for so costly a residence the valuation to be placed upon it under the statutory criterion should be correspondingly depreciated. The criterion established by the statute is a hypothetical sale, hence the buyers therein referred to are hypothetical buyers, not actual and existing purchasers.

One notes in this case a rejection both of an out-and-out market value criterion and of an out-and-out value to the owner test. On the one hand the court refused to reduce the tax to the low price for which "so costly a residence" would have to be sold in view of the dearth of actual wealthy buyers, and on the other hand it did make some abatement in view of the fact that the existing owner had embodied in his residence queer ideas which would not be appreciated by anyone else. In other words, the court was willing to indulge in the hypothesis that there would be other wealthy persons who wanted large, handsome residences in that community, but was unwilling to extend the hypothesis to assume that these wealthy individuals had the same odd tastes as the present owner.

* * * *

Conclusion

The confusion as to the meaning and measure of value that one finds

[8] Smyth *v.* Ames, 169 U.S. 466 (1898) and other public utility rate cases were relied upon.

[9] N.J. Laws 1903, p. 398, section 6.

[10] Turnley *v.* Elizabeth, 76, N.J.L. 42, 68 Atl. 1094 (1908).

[11] *Id.* at 44, 68 Atl. at 1095. The doctrine of the hypothetical buyer was approved in United N.J.R. & C. Co. *v.* State Board, 100 N.J.L. 131, 125 Atl. 355 (1924). See also General Electric Co. *v.* City of Erie, 110 Pa. Super. 206, 212, 168 Atl. 531, 536 (1933).

in the administrative practice and in the judicial rulings on real estate assessment is not the type of confusion that can ever be cleared up by the professional appraiser or by the value theorist. The trouble lies far too deep to be cured by either of these economic skin specialists. It lies in the absence of any valid philosophy for the general property tax or for the general real estate tax. Only if and when the experts in public finance can answer the prior question, Why should all owners of real property pay the same rate of tax on the value of their property? will the value specialists have any premise from which they can derive a conclusion, say, that value should be construed to mean replacement cost rather than commercial value. But all attempts to answer this prior question have so far broken down; and the hopelessness of the effort is now conceded by the most competent authorities in fiscal science.

It follows that what is needed is a reform of our whole system of real estate taxation. One must begin, not with the question how real estate should be valued for tax purposes, but with the question why real estate should be singled out for any special form of taxation. Certainly the ability to pay doctrine can no longer be adduced in support of a discriminatory burden on realty. Whatever force there may once have been in the argument that people's total wealth corresponded roughly to the values of their houses and lots, has disappeared with changing economic conditions. If a real estate tax can be defended, it must be supported on other grounds. The most plausible of these grounds are first, that suggested by the philosophy of the single tax, and second, that suggested by the probability that the expenses of local government grow more closely in proportion to real estate development than in proportion to increments in other forms of private wealth. But the former theory requires the complete tax exemption of improvements on land, while the latter theory may possibly suggest the very contrary conclusion, namely, that only improvements be taxed, and that the tax be measured by such indices as relative costs, relative size, and character of construction rather than by relative commercial values.

Fortunately for his peace of mind, the present writer is not a tax specialist and may therefore content himself with raising these baffling problems without venturing to solve them. But as long as the general property tax remains in effect, it must be administered as well as possible, and its administration calls upon tax assessors and courts to muddle through with some form of assessments. As this article is concerned primarily with the legal decisions, a few concluding comments of the doctrinal law are therefore in order. These comments may be prefaced with the statement that, considering the difficulties inherent in the whole system of real estate taxation, the courts have done their share of the job remarkably and abstemiously well.

1. The law should abandon in words, as it has generally abandoned in fact, the dogma that market value constitutes the proper basis of tax assessment. Unless market value is interpreted to mean literally the price at which the present owner could actually sell his property to someone else, it is a meaningless and delusive term. But only the Wisconsin courts have had the courage to interpret market value in this literal sense, and

in their case discretion would have been the better part of valor. Other courts have invoked the fiction of a "fair market value" as fixed by a hypothetical willing buyer and willing seller. But this is mere subterfuge. The New York opinion in the Stock Exchange case, frankly recognizing that the market value standard is inapplicable to unique types of property, is far preferable.

2. If the general property tax is interpreted as a "faculty tax," value to the owner is a better standard of assessment than market value. On the other hand, if this tax is designed fairly to allocate to property owners the costs of government made necessary by the construction and operation of their properties, undepreciated replacement cost has a shade the better of the argument as a proper tax base.

3. But whatever may be said for the replacement cost standard of assessment in its own right, and not merely as a "measure" of value, its frank adoption would do such violence both to popular tradition and to legal doctrine, that there is no immediate hope of securing its acceptance. That being the case, the courts are well advised in pursuing their past policy of accepting replacement cost assessments unless the taxpayer can bring convincing evidence that his property is worth an amount measurably less than replacement cost.

4. The contention of taxpayers that their property should not be assessed in excess of the low market prices prevailing during the business depression is unacceptable for practical reasons. It could be sustained, if at all, only on condition that the present statutory and constitutional limits on governmental debts and on the rates of taxation be repealed.[12] Unless these limits are removed, assessors and courts will be forced, willy-nilly, to pretend that real estate is now worth more than it really is worth.[13]

[12] But see *In re* Lehigh & Wilkes-Barre Coal Co.'s Assessment, 298 Pa. 294, 304, 148 Atl. 301, 304 (1929), in which the court recommended the lessening of government expenditures as the solution for similar difficulties.

[13] The writer has deliberately stated these four points in dogmatic form. He intends to incorporate this article in a treatise on the valuation of property, and he hopes to stimulate strong critical reactions before putting the material into final shape.

18

SIMEON E. LELAND

Some Observations Concerning the Classified Property Tax *

The classified property tax developed as one of the important movements for the reformation, or the modification, of the general property tax.[1] The essence of classification is the differentiation in the effective rates of taxation applied to various classes of property.[2] It stands in sharp contrast to the general property tax which attempted to tax all property at a uniform effective rate. This differentiation in effective rates under classification may be the result of law, of administrative action, or it may unintentionally or indirectly result from the operation of law, or the action of public officials. The differentiation may be sanctioned by constitutional provisions or court decisions; it may be extra-legal, if not absolutely contrary to law, as instances of illegal classification are not unknown.

Methods of Securing Rate Differentials

The rate differentials so necessary to classification may be secured through outright variations in tax rates, through the use of fractional assessments for different classes of property, through fixed assessments made without reference to values but which produce variations in effective rates, through the use of different methods of valuing property for taxation which because of peculiarities in the valuation formulae produce rate differentiations; or, classification may be brought about by the use of varying exemptions applied to different classes of property. Various combinations of these practices may also bring about classified tax rates. Perhaps in other ways rate differentiations may also be produced. It is important, however, that the variations in rates be uniform as to classes of property and large enough to be significant. Errors of judgment, faulty assessment, mistakes of law, accidents in administration and other unintended events can hardly be construed as instances of classification. If, however, such practices should become recurrent and the differential burdens thus effected could be considered substantial, classification might result. Such instances are generally unimportant.

* * * *

The forms or varieties of classified property taxes are numerous. They

[1] The early differential property taxes are not here considered.

[2] For a more complete statement, see Simeon E. Leland, *The Classified Property Tax*.

* Adapted from *Property Taxes*, pp. 83–116. Reprinted by permission of the Tax Institute, New York.

include low-rate taxes on intangibles, mortgage recording taxes, preferential taxes on bank deposits, taxes on bank shares, bushel taxes on grain, tonnage taxes on ships, ad valorem taxes on mineral production, forest taxes, special treatment of land and buildings, the exemption of improvements, homestead exemptions, the partial substitution of service charges for property taxes, and many others. In short, all cases of property taxation, of whatever type, involving differentiations in effective rates are included. Whether differential rates exist is a fact to be determined, often only by careful research. But classification is as extensive as the rate differentiation. Whether the differentiations are wise is also a subject for research. So great is the variety of taxes embraced under the folds of classification that it is impossible to summarize the research findings or the operative results in all of these fields. A few sporadic examples must therefore suffice.

Classification of Intangibles

It has frequently been said that the success or failure of classification depends largely upon the degree to which it solves the problem of taxing intangibles. As a matter of fact many individuals think the essence of classification is here. Some also believe that if the problem of taxing intangibles can be solved, through classification or some other means, the remainder of the property tax can be rigorously and uniformly enforced. It is doubtful if the general property tax minus intangibles can be successfully resurrected. The taxation of personal property in one category still remains an obstacle. Likewise it is doubtful if the merits of classification rest on the results from taxes on intangibles. The treatment of intangibles, however, has played a large part in the classification movement.

It was demonstrated many years ago that the classification of intangibles was fundamentally more equitable than their taxation at the same high rates as prevailed for real estate. It was also found to be true, in most states, that the revenue produced by the low-rate taxes exceeded that from the higher rates of the general property tax.[3] Thus greater justice produced greater profits for public treasuries. Some of these gains did not appear until a considerable amount of time had elapsed and no little administrative effort had been exerted. Moreover, without efficient centralized administration the achievements of low-rate taxation of intangibles would have been desultory. Classification is not a self-executing reform; nor do low rates completely reform taxpayers. They have made it possible, however, for them to be reasonably fair with the state in filing tax returns. Psychologically the result has been good—that has made the enforcement of the rest of the property tax easier, but that abundant revenues have not been produced is really no fault of the plan. Had the declarations been perfect, the productivity of these low-rate taxes would still not have come up to the predictions of many ardent campaigners in their behalf. There is no question but that many voters have been led to expect far too much in revenues from classified property taxes of every variety. Justice, not productivity, is their major virtue.

In 1930, a special tax committee in

[3] See Simeon E. Leland, "Results of Operation of the Classified Tax on Intangibles," *1928 Proceedings*, National Tax Association, pp. 292 ff. and 554.

Ohio, after a study of the results of low-rate taxes in other states, emphasized the incompleteness of voluntary assessments under these laws and stressed the importance of employing collection-at-the-source wherever possible.[4] The committee had no illusions as to the revenue productivity of these taxes.[5]

In 1932, Blakey in his study of *Taxation in Minnesota* subjected the low-rate taxes of that state to the most searching examination. Whereas Compton and myself had previously attempted to evaluate intangible taxes on the basis of presumptive indices,[6] Blakey sought an answer to the question of the completeness of assessments on the basis of data taken from the examination of 805 estates in 18 counties. He found that only 6.03 per cent of money and credits were taxed and only 17.33 per cent of those taxable were listed. Blakey naturally concluded that there was little to boast of in this record and stated: [7]

One may raise the question whether such property should not be taxed by some more successful method or removed entirely from the tax rolls. Inasmuch as the physical property underlying most of these intangibles is already taxed, perhaps they should not be taxed at all; or possibly the taxpaying capacity represented by them can be reached more equitably and practically through an income or other tax.

Ford in his recent study of the *Taxation of Intangibles in Michigan* took occasion to analyze the practices of several states, particularly of Ohio, where a comprehensive system of classification is in force.[8] The conclusions of this investigation are similar to those heretofore given. For example, Ford believes that the classification of intangibles in Ohio is an improvement over the general property tax even though the taxes levied on intangibles were not so great up to 1937 by several millions as those previously levied under the general property tax.[9] These disappointing

[4] *Report of the Committee on Taxation of Intangible Wealth* (submitted to the Governor's Taxation Committee, Columbus, Ohio, December 24, 1930), pp. 3 ff. See also *A Study of Low-Rate Taxes on Intangible Property in Various States and Probable Yields of Such Taxes if Applied in Ohio* (Third Preliminary Report of the Committee on Research Submitted to the Governor's Taxation Committee, Columbus, Ohio, November 12, 1930.

[5] *Report of the Committee on Taxation of Intangible Wealth* (submitted to the Governor's Taxation Committee, Columbus, Ohio, December 24, 1930), pp. 5–6.

[6] *A Study of Low-Rate Taxes on Intangible Property in Various States and Probable Yields of Such Taxes if Applied in Ohio* (Third Preliminary Report of the Committee on Research submitted to the Governor's Taxation Committee, Columbus, Ohio, November 12, 1930); Leland, *loc. cit.*

[7] Roy G. Blakey, *Taxation in Minnesota* (Minneapolis: The University of Minnesota Press, 1932), p. 217.

[8] Robert S. Ford, *Taxation of Intangibles in Michigan*, Chap. 3. The Ohio system of taxing intangibles, in brief, is as follows: Intangibles yielding income are taxable at 5 per cent on income yield; non-income-bearing investments, bank shares, bank deposits, shares in and capital employed by financial institutions, capital and surplus of domestic insurance companies are taxed at 2 mills. Money and credits are taxable at 3 mills. Shares of dealers in intangibles are taxed at 5 mills. *Laws of Ohio*, 1931, p. 722; *Laws of Ohio*, 1933, p. 592; Throckmorton's Ohio Code Annotated, Baldwin's 1936 Certified Revision, Sections 5414–9, 5414–13, 5638–1.

[9] Total taxes levied on intangibles in millions:

1930	$23.3	(last year of general property tax)
1932	18.5	
1933	13.9	
1934	12.2	
1935	14.5	
1936	14.4	
1937	18.4	

Ford, *op. cit.*, pp. 95, 99.

results were attributed to the shortness of time within which classification had been effective and to the economic consequences of the depression. Nevertheless, Ford was certain that Ohio had fared better under classification during the depression than would have been the case had the general property tax been continued. The dual administration of the taxes by both state and local authorities also contributed to the disappointing results of the Ohio system. Collection-at-the-source of the bank deposit tax, on the contrary, was quite effective, and in line with the experience of other states. The Ohio system with its differentials among various classes of intangibles has to date contributed little to the improvement of either the theory or the practice of classification.

* * * *

Extra-legal Classification in Cook County

Although administration has played an important part in the success of low-rate taxation, it is not the only factor to emphasize. This is indicated by recent experience in Cook County, Illinois, where extra-legal classification in one form or another has been the rule almost since 1898.[10] This classification is purely administrative. At first the privileges of classification were limited to a few select friends and campaign contributors; later the system was extended to banks and others but still confined to "those who know"; about 1932 a "friend" of the assessor notified the community that the assessor would respect "custom and usage" with reference to intangibles; [11] finally, a few

[10] Cf. Altman, *Chicago's Experiment in Personal Property Taxation: 1931–36,* especially Chaps. 1, 2, and 6.

[11] These recommendations were made by Mr. George O. Fairweather in *Appraisal Standards for the Assessment of Personal Property* (Report V, Joint Commission on Real Estate Valuation, Cook County, Illinois, July, 1932), pp. 11–12, as follows:

"Item 26—moneys of other than bank, banker, broker or stock jobber. Money of banks and money belonging to domestic corporations is not assessable as such, being one of the elements going to make up the assessable value of the capital stock. In other jurisdictions where moneys are taxed as property, an effective rate on the average of 2.2 mills is employed. This rate does not tend to precipitate the flight of deposits from such jurisdictions. For purposes of comparison only, a similar result in Cook County would be had under local rates and equalization factor, on a basis of 10 per cent. For example, at a $6 rate and 37 per cent equalization factor, the use of this percentage would produce a tax of $2.22 per $1,000.

"Item 27—credits of other than bank, banker, broker or stock jobber. The general intent of the statute is to balance current debts against current credits, excluding all productive investments, such as notes given as security for money loaned. Notes or other obligations for money loaned are added to the net credits, if any. With regard to the appraisal value to be assigned to such obligations (such as notes secured by mortgage or trust deed) an appraisal of 20 per cent of the value produces a 4.4 mill tax or twice as much as the net rate on money as employed in other jurisdictions, as indicated under Item 26 above. On a 6 per cent mortgage this rate takes approximately 7 per cent of the income; on a 5 per cent mortgage this rate takes approximately 9 per cent of the income; on a 4 per cent mortgage this rate takes approximately 11 per cent of the income. The effective tax thus developed is comparable to and in most cases higher than any income tax rate. In 17 states having a mill tax on this subject matter, the average runs between four and five mills.

"Item 28—bonds and stocks. See Item 27 above. (There is a common and mistaken notion that municipal obligations are tax exempt. This may be due in part to the fact that representations are said to have been made at the time of the sale of such obligations that they are exempt from personal property tax.)"

years ago, the assessor publicly promulgated an administrative twofold classification of intangibles for the benefit of the whole community. In 1936 federal income tax returns were made available to the assessor to enable him to make better estimates of taxable securities. This information was used in making the 1937 assessment. At present, money, cash, and bank deposits are assessed at 10 per cent of their value, or at 10 per cent of twenty times their annual income, whichever is lower.[12] In the case of cash and bank deposits, the annual income is not to be taken at less than 2 per cent, which means that this property is to be assessed at 4 per cent. This system is used also on non-income-bearing securities. Stocks and bonds of the income-yielding variety are assessed at 10 per cent or at 10 per cent of 20 times their income, whichever is lower.[13] This is substantially the system of classification that has prevailed in Cook County in recent years. At times bank deposits and non-income-bearing securities have been assessed at 10 per cent, while other personal intangibles have been assessed at 20 per cent. Still other rules have prevailed for corporate intangibles (corporate excess), tangible personalty and real estate. Prior to 1930, however, no effort was made to assess intangibles. As a result, the assessment of money, stocks, bonds, net credits, notes and mortgages was only $4,654,000 in 1930 and $6,162,000 in 1929. These sums were less in those years than the assessment of intangibles in any state having low-rate taxes.

After 1930 a determined effort was made to increase the assessment of intangibles with the result that the 1931 assessment rose to $90,410,000. Subsequently, the total assessment of this property declined to $63,529,000 in 1932. Thereafter it increased fairly continuously until in 1937 the assessment of intangibles reached an all-time high of $163,830,000. After that assessment was completed, the assessor cut his valuation system in half, with the result that assessments fell to a little less than $79,000,000 in 1938.[14] For the assessment year 1937, federal income tax returns were utilized by the assessor, and as a consequence, the assessment of stocks and bonds alone more than doubled, ris-

[12] See instructions of assessor as printed on assessment schedules for 1939 as follows:

"Item No. 12. Money, Cash, and Bank Deposits: List cash on hand and on deposit as of the assessment date at ten (10) per cent of full amount, or at ten (10) per cent of twenty (20) times the annual income, whichever is lower; provided, however, that in the case of cash and bank deposits the annual income rate shall be taken to be not less than two (2) per cent.

"Item No. 13. Net Credits: List accounts as computed from memoranda on the front page of assessment schedule at ten (10) per cent of the amount determined. Credits are receivables; deductions are payables.

"Item No. 14. Taxable Stocks and Bonds: List taxable stocks and bonds at either ten (10) per cent of the market value as of the assessment date, or at ten (10) per cent of twenty (20) times the annual income for the preceding year, whichever is lower. Where no income is derived from certain securities, the annual income rate shall be taken to be two (2) per cent of the market value as of the taxable date. Where the fair cash value of any security is incapable of ascertainment under the above rules and guides the particular facts which take it out of the rule must be stated on the schedule or letter and the method determining the fair cash value endorsed thereon.

"Item No. 15. Mortgages and Notes: Use same method as outlined in Item No. 14."

[13] *Ibid.*

[14] In 1937 bank deposits and cash were assessed at 10 per cent while securities were assessed at 20 per cent. In 1938 these percentages were reduced to 4 per cent and 10 per cent respectively.

ing from $64,000,000 in 1936 to $145,000,000 in 1937.

This record in Cook County indicates progress in increasing assessments. It is no mean achievement for a local assessor. Nevertheless, the record of Chicago (Cook County) is disappointing (prima facie) if comparisons are made with assessments in other places. In 1938, the assessment of intangibles in Cook County was less, for example, than the assessment of intangibles in Connecticut, Nebraska, or Kansas. In Baltimore, the assessment of intangibles was six times greater than in Cook County; in the District of Columbia, it was seven times greater; in Iowa, it was four times greater. The assessment of intangibles under the three-mill tax in Minnesota reached $684,000,000 almost without effort, while the most rigorous use of information collected-at-the-source produced an assessment of less than $79,000,000 in 1938 in Cook County, Illinois.

* * * *

Comprehensive Classification Schemes

The comprehensive classification schemes are found by law in Kentucky, Minnesota, Montana, Ohio, Virgina and West Virginia. Within given states many of the classifications have little to recommend them. They are based upon questionable assumptions, reflecting political or other pressures rather than sound economic distinctions. Moreover, the more numerous the subdivisions into which property is divided the more questionable from the viewpoint of economic logic do the classifications and the rate differentials become. It is easy to point out defects in particular classifications—and many of the criticisms are rooted in personal opinions and economic beliefs subscribed to by the critics—but it is extremely difficult to say just what the classifications should be and far more difficult to lay down principles on which rate differentiations may be fixed. These questions, in considerable part, lie in the field of policy determination—in the field of practical statesmanship—rather than in the field of economic logic or of public finance in its usual narrow sense. The classification policies, however, must be evaluated in terms of their effects, taking into account social, political and economic results. This task involves far more research than is at the moment available. Attention must, unfortunately, be restricted to the mere mention of legislative policies. It is to be noted that Kentucky still subsidizes manufacturing; Minnesota still discriminates against its iron resources but not as heavily as before; Ohio draws a line between tangible personal property and personal property used in business, and between productive and unproductive investments; West Virginia differentiates between rural and urban property, as does Minnesota. Agricultural products are accorded preferences in Kentucky, Minnesota, Montana, Ohio and West Virginia. Household goods are specially classified in Minnesota and Montana. A number of other states also exempt such property.

Some of the systems, thus, seem to provide a difference in treatment for producers and consumers goods. Both from the standpoint of *ad rem* taxes and from the use of property as a criterion of personal capacity this distinction seems to be basically sound. Few of the systems which have such subclasses of property seem to have applied this differentiation

fully. In 1919, the Committee on Model Plan for State and Local Taxation recommended a separate classification for tangible personalty as distinct from real estate, it being recommended to exempt intangibles. The rate suggested for tangibles was not to exceed $1.00 per $100 and minimum exemptions of $200 to $400 were suggested.[15] In 1933, when the National Tax Association received a Second Report from its Model Plan Committee, it was reported that the Committee differed with reference to the desirability of classifying tangible property.[16] Professor Bullock thought that tangible personalty should be classified, the other members of the Committee did not. The Committee seemed to be swayed by revenue considerations and the belief that legislatures would not willingly classify tangible personalty. An additional reason was advanced, to wit: "the success which has attended efforts made in some communities to tax tangible personalty more effectively under the general property tax." In a footnote the Committee cited Chicago as perhaps the best example of a community which was trying to rejuvenate the personal property tax. The recent experiment in Chicago seems to lead to the same conclusions as previous attempts to tax personal property under general property tax conditions.

Expediency here as elsewhere is seldom an adequate answer to the problem of taxation, even so far as classification is concerned. Rigid enforcement has been tried frequently enough to indicate to students of property taxation the probable outcome of such efforts. Rigid enforcement does not provide the alternative to classification. Moreover, the enforcement methods employed have not yet been rigorous enough to produce either adequate or complete assessments of personal property. It is doubtful if taxpayers are yet willing to accede to the kind of administrative methods needed to produce even reasonably complete inventories of personal property. Vigorous efforts to enforce the property tax have been attempted before but there is little reason to believe that this portion of the property tax can be so rejuvenated that it will operate equitably as between taxpayers. It can be administered so as to produce more revenue but to do this will require continuous as well as large amounts of administrative effort.

If we look at the progress of the movement for classification it appears that it is now definitely on the wane. It is not a major problem in state and local finance. These units have recently been seeking lucrative sources of additional revenue. They have turned to sales taxes, income taxes and other devices to get the revenues required for depression or current needs. The limited revenue-raising propensities of classification may, among other things, have caused few states to adopt such measures in the last few years.

* * * *

Evaluation of Classification

The principal service of classification has not been as a fiscal measure to fill public treasuries but to provide greater justice and flexibility in the operation of the property tax. Its main contribution, too, has been in the field of constitutional reform. It has given legislatures greater freedom in the taxation of property and has

[15] *1919 Proceedings,* National Tax Association, p. 445.

[16] *1933 Proceedings,* pp. 383–384.

demonstrated that, by and large, these assemblies can be trusted in adopting tax measures not to abuse seriously the privileges conferred upon them. To be sure, no one will approve of all of the classification measures which have been adopted, but the history of classification does demonstrate that legislatures will act with reasonable wisdom when given broad constitutional powers relative to taxation. And, if property is to be taxed the legislature should possess the right to classify property. The prudence of "wide-open" constitutional provisions concerning taxation has been repeatedly demonstrated.

Moreover, it would seem that classification may well find a place under a system of taxes *in personam*. Once the property tax was a tax designed to measure the capacity of the owner to contribute to the support of government. Soon the yardstick of capacity was forgotten and the tax became a levy upon things. Within the *ad rem* framework classification came to have a relation to capacity to pay; at least writers spoke as though it did. It was argued that some property could stand the impact of taxes better than other property. Differences between properties were translated into differences in capacities to pay. Within such a framework this sort of logic may *perhaps* be defended, but the measurement of taxable capacity is really a personal matter. People, not things, bear the burdens of taxation. Just how taxable capacity is to be measured may be open to debate. Perhaps the capacity of individuals to pay taxes may be measured through a combination of income and wealth. If wealth is considered, doubtless all forms may not be counted alike or given equal weight in the computation. Just as funded and unfunded income are differentiated, so different types of wealth may be distinguished. The differentiation of unlike things is the essence of classification. Such differentiations are vastly broader than property taxation. They underlie the whole field of government support. If, however, the property tax should be converted into a net fortunes tax some use of the classification principle would seem to be in order.

In conclusion it may be said that the place of classification in the fiscal system depends on the components of the tax system. It may find a place among many taxes. It may not be utilized as to intangibles but to tax forests, or to extend preferences to buildings or homes, or in the severance of minerals, or in the taxation of household goods.[17] It may take other forms. Wherever classification makes its appearance it is presumably because the objects or sources of taxation are not alike, and the legislature desires to differentiate among them. Classification cannot be touted as a great revenue producer. Where it is advanced it must be because of the justice its application involves. It stands for an increased degree of constitutional freedom and the right of legislatures to experiment in the solution of property tax problems. In this course there is hope. Here classification performs its best service.

[17] This is a possibility for the future, not an argument in favor of these practices, nor an implied condemnation of them.

RAYMOND D. THOMAS, CHAIRMAN

Report of the Committee on Property Tax Limitation and Homestead Exemption

TWO important modifications of the general property tax that came into the limelight during the thirties were rate limitation and homestead exemptions. The National Tax Association appointed a committee to examine these innovations. The committee's report follows: *

I. *Abolition of the Property Tax*

1. *Conclusion*

The proposal to abolish the property tax and to substitute therefor some other source or sources of revenue we believe is both undesirable and impracticable. The prospect which this proposal apparently offers for tax reduction to so large a mass of taxpayers is a decided advantage of strategy. The proposal cannot be passed up as a mere fancy of so-called "radical" tax reform advocates. The possibility that well-organized and directed campaigns may result in the adoption of the proposal is ample cause for real concern.

Few critical students of taxation would believe that the property tax can be eliminated from the local tax systems in the United States, although many may be found who would advocate the discontinuance of levying general property taxes for state purposes. Most if not all students would probably favor the modification of the property tax materially. There is, however, a lack of general agreement on the character and extent of the desired modifications. We deem it advisable, therefore, to consider briefly the pressing necessity for the retention of the property tax as the extraordinarily productive revenue means it has been, to present such rationalization or justification as can be made for this inevitable tax, and to indicate the devices by which it may be more effective and less inequitable in its application and operation.

2. *Local Dependence Upon the Property Tax*

It is a plain fact that our local governmental units—counties, cities, school districts and others—have had some, and quite costly, public services assigned to them. Another way of saying the same thing is to say that American taxpayers in each community (taxing district) have had the priceless privilege of spending their own money in their own way and for purposes of their own choice to a degree that is probably unex-

* *1938 Proceedings,* National Tax Association, pp. 788–804.

celled anywhere. Under this scheme of local fiscal autonomy enormous amounts of public funds have been raised and spent. This decentralization of public services and fiscal responsibility has its drawbacks, but the net advantages are so great that the practice should be continued wherever it does not lead to fiscal chaos. Local fiscal autonomy, however, should not in practice exclude proper and locally acceptable supervision by the state over assessments and public expenditures, in the interest of public economy.

Another equally plain fact is the absence of any possible substitute revenue source that is at the same time fiscally adequate and capable of local control and administration. Wealth, particularly real estate, is peculiarly tangible and measurable, and must necessarily have a *location* in a tax district. It cannot easily get away. The aspect of *wealth* that renders it such a peculiarly suitable measure and base of local taxation is its inability to escape. Other bases or measures can and do escape far more easily, or would probably do so if they were used as a source to raise such huge amounts of revenue as flow into the local treasuries from taxes on property. The geographical distribution of tangible property is far from being equal. It is, however, more equal than any other source or measure could reasonably be expected to be. One needs but to try to allocate, say, the income tax or the general sales tax to local governments in proportion to the origin or place of collection in order to be convinced of this fact. On the revenues from these taxes, collected locally, local government could not exist.

3. *Rationalization of Property Taxation*

The property tax can be rationalized in terms of both the ability-to-pay principle and on the benefit principle, as well as on the grounds of fiscal adequacy. But the explanations will differ according to varying conceptions of taxable property. Taxable property can be regarded in three ways. State tax laws attempt to use all three of them, and for this reason the property tax is a hodgepodge. The property tax has grown in an unplanned way during a period of some 300 years, involving perennial and half-hearted attempts to patch it up to conform to changes in economic society. As a result there is confusion of ideas as to its nature and justification.

* * * *

The report is here abridged by the omission of the remainder of this and all of the next two sections. In the omitted portion the Committee first discusses three concepts of the property tax, pointing out that the tax may be regarded as a personal levy on net worth, an impersonal levy on wealth as such, and a levy on rights in property. The tax in practice suffers from a confusion of these concepts. Giving major weight to the fiscal necessities of local units, the Committee concludes that probably the second concept should prevail.

Sections on the defects and on the necessary modifications of the property tax follow. Among the modifications recommended are improved

administrative organization and procedure, some transfer of functions from local to central units of government, more grants-in-aid financed out of other taxes, and a redefinition of the tax base to exclude intangibles and tangible personal property in the hands of consumers.

II. *Property Tax Limitation*

The question of property tax limitation has been bandied about in our annual conferences for a number of years. The committee comes to the statement of its conclusions on this controversial question with the feeling that our statement will probably come far short of a model or final disposition of the limitation issue. But we are certain that our assignment requires us to make our statement of conclusions definite and clear-cut.

1. *Definition of Property Tax Limitation*

A first requisite is an understandable definition of "property tax limitation." For the purpose of stating a conclusion we have considered property tax limitation to mean the establishment of an *overall* or upper limit on the property tax rate, a ceiling rather rigidly fixed by the state in constitutional provisions or even in statutory provisions. This upper limit would operate to restrict the constituents of local governments in exercising control over the property tax as practically the sole or principal source of support of local services. Our definition excludes from *property tax limitation* the establishment by constitutional or statutory provisions of lower and upper limits between which proper local authorities can fix specific or total levies without the requirement of a vote of the people. The establishment of this zone within which ordinary budgeting procedures can operate is a practical necessity. Excluded from our definition are any workable safeguards against the creation of public debts by local administrative authorities which would constitute a lien on property by reason of revenue requirements to amortize the debts. Excluded, also, are statutory provisions safeguarding against extravagance in local government budget construction or against mismanagement or misappropriation of public funds.

2. *Conclusion*

We have approached our conclusion from the position of excluded middle ground. In terms of the limited meaning of property tax limitation as stated in the preceding paragraph and in the presence of carefully stated positions on tax limitation—pro and con—and, further, with full consideration of analyses of the effects of tax limitation in actual practice, together with consideration of tax theory, we have thought in both directions from the excluded middle toward an unequivocal affirmative position or an equally unequivocal negative position. We have arrived at an unequivocal negative position.

Our conclusion is that property tax limitation, as we have defined its meaning, is not in accord with sound tax theory and practice.

3. *A Movement of Mixed Purposes*

Advocates of property tax limitation are apparently not agreed on the choice of emphasis as to the most important end to be achieved by the

movement. Some advocates emphasize the purpose of protecting property values, particularly real estate, against confiscatory tax burdens. Others see in tax limitation an effective method of realizing desirable modifications in the whole tax scheme. A third emphasis is that of using tax limitation as a means for forcing a retrenchment in government expenditures. Still others would apparently emphasize property tax limitation as a first step toward a fundamental change in our American tax practice, probably to the extent of complete abandonment of the property tax. It is manifestly difficult to appraise a proposal for "tax reform" with motives and purposes so mixed as these.

Concerning the last purpose—the elimination of the property tax—the committee has stated its position in Part I of this report. For purposes only of clarifying our conclusion that property tax limitation, as we have defined its meaning, is not in accord with sound tax theory and practice, we could agree that each of the first three objectives is desirable, and at the same time we would advise against taking the tax limitation route toward the goals sought.

4. *The Property Tax in a Tax System*

No one would seriously propose that the property tax should be used as the sole source of support of all government services (federal, state, and local). Likewise, few persons would contend that all the costs of government should be paid from any other single source—net income tax, gross income tax, consumption taxes, severance taxes, or any other kind of tax. An exception would be the proposal of a "single tax" on net land income (economic rent), which is a tax on property in land as such. Our American experience in seeking to achieve the ideal of justice in taxation has resulted in the use of many revenue sources in a combination which we call a tax system. The larger and inclusive problem of financing government can be stated in terms of two sub-problems; namely, (1) that of determining the amount of public funds which should be raised and expended for public purposes during a given current or longer period of time, and (2) that of determining in terms of the general welfare the most satisfactory ways to provide the necessary funds. Each of these sub-problems should be approached from the positive point of view. Tax limitation smacks rather strongly of a negative approach.

We would not restrict our conclusion regarding tax limitation to the property tax. The setting up of barriers by rigid legal enactments beyond which the rate of any kind of tax cannot go, we believe would be equally as unwise as an overall limit on the property tax.

5. *Is it a Choice Between Limitation or Confiscatory Property Taxes?*

It may be that advocates of tax limitation who are hearing this report (or reading it) are interpreting the position of the committee to mean that the bars should be lifted, thus allowing the "tax spenders" to run wild and to lay upon the taxpayers unreasonable and economically unwise burdens. They may be asking the question: Have the taxpayers not learned by experience that only by rigid limitation legislation can wasteful current public expenditures be avoided, and the piling

up of public debts be effectively checked?

Such an interpretation of the conclusion of the committee is incorrect. We desire to say most emphatically that we have little patience with those who are continually aligning the *tax payers* in battle against the *tax spenders*. Drawing artificial distinctions of this kind and feeding the fires of such an imaginary war, in our judgment, contributes little in a positive way to the establishment of the public service on a stable fiscal basis, or to the building of a sound tax system.

Is it, after all, a choice as between the alternatives of property tax limitation or inequitable and possibly confiscatory property taxes? Is the choice necessarily one as between property tax limitation or uncontrolled, extravagant, and wasteful public expenditures? Much of the tax limitationist literature would at least appear to imply that the choice is between the alternatives indicated. If such a choice be inescapable, the committee would without hesitation choose the tax limitation alternative. But such a choice is not necessary. Setting these two alternatives in contrast, to the exclusion of other choices, is illogical and unscientific. Reliable conclusions could not be expected to be derived from such a procedure.

6. *Control versus Limitation*

The committee desires to stress with particular emphasis the advantages of a positive approach to problems of public finance. In a democracy, government is an agency of the people. The people establish government. They should be expected constantly to assume responsibility for the control of its activities. Control by the people is an essential of primary importance in a democracy. If democratic government is to be dynamic and adaptable to varying social and economic conditions, the controls over government by the people must be flexible and, therefore, adaptable to change. In no aspect of the whole problem of government is control more important than that of taxation. *Control* in relation to public expenditures and taxes, in our judgment, is quite superior to *tax limitation*. Workable controls can accomplish the desirable results sought by tax limitation.

Limitation of space forbids a detailed discussion of the possibilities of *control* as a guiding idea in shaping tax policies and practices. We consider it unwise to resort to the method of limitation applied to the property tax or to any other tax until positive effort has been made to exhaust the remedies of control for the ills of public finance. Following are activity areas in which the instrument of control can operate: (1) The preparation of the budgets; (2) The administration of budgets; (3) The authorization of new indebtedness, funded or unfunded; (4) Tax administration; (5) The balancing of the various sources of revenue within a system in the interest of social justice and economic stability; (6) Intelligent guidance of the growth of government activities in the interest of the general welfare; and (7) State agencies to serve in an advisory capacity to local governments with respect to each of the foregoing.

With the recent increase in service business activities of government has arisen a need for a new use of control in the interest of protecting taxation within its true sphere. Revenue bonds issued in connection with

so-called self-liquidating projects, such as waterworks, hydroelectric plants, electric light plants, college dormitories, toll bridges, or for any other business activity of government should not carry a secondary security in the nature of a lien on tax revenues. But tax limitation is not the most desirable method for protecting the taxpayer against levies for interest and principal payments in connection with revenue bonds. By proper legislation the purely business activities of government can and should be entirely severed from the area of taxation.

III. *Homestead Exemption*

The preliminary report of this committee in 1936 (1) warned against hurried action by the people of any state in adopting homestead exemption, (2) expressed its belief that the acceptance of the idea of homestead exemption with its wide popular appeal might afford political rivals a convenient opportunity to offer attractive promises for further extension of the exemption in both area and value, (3) expressed doubt that homestead exemption is a sound method for encouraging home ownership, and (4) indicated the possibility of troublesome difficulties in the administration of the exemption plan.

The 1937 report by implication accepted the foregoing tentative conclusions and added (1) that homestead exemption in practice tends to cause an increase in the tax rate on the property base remaining after the exemption is applied, (2) that in operation homestead exemption results in wide differences of economic effects between owners of small homes and owners of large homes, between owners of urban homes and owners of rural homes, between areas of high percentage of home ownership and areas of low percentage of home ownership, between areas with relatively large assessed valuation of business and industrial property and areas of limited amounts of such property.

1. *Conclusion*

Our observations on trends of the movement during the past three years and our careful consideration of the thorough studies which have been completed in several states not only confirm the tentative conclusions summarized above, but support the firm conviction of the committee that homestead exemption is unsound and that the movement should be positively resisted in the interest of building sound and stable tax systems.

2. *Homestead Exemption and Home Ownership*

Homestead exemption advocates urge its desirability on grounds of encouraging home ownership. There is probably general agreement that home ownership should be encouraged. By and large, a family with stable income and whose employment is reasonably certain to continue in a community will likely find it desirable to own its home. Much can be said in favor of a high percentage of home ownership as a condition contributing to social, economic and political stability in a community. However, there are many and practical reasons why in a world of a mobile population families would not find it desirable to own their homes. This would be the case even for persons or families of large and stable income. For those numerous families whose incomes are inadequate, and who must, there-

fore, acquire their homes on the installment plan, or whose income is uncertain because of irregular employment and who may, therefore, lose their partially-paid-for homes through foreclosure, home ownership is a hazardous venture. It is a doubtful question whether government, through tax exemption, should stimulate the purchase of a home when there is no reasonable prospect of stability of income adequate to guarantee that the home will not be lost. The number of mortgage foreclosures even in prosperity, but, of course, much greater in a depression (unless moratoria and other staying devices are employed), is appalling enough to give pause to a venture to stimulate home ownership by a tax exemption premium among a class of inadequate and uncertain income.

Will tax exemption cause an increase in home ownership? The exemption plan has not been effective long enough to warrant an attempt to answer this question by objective analysis. An answer arrived at deductively must be in the affirmative, at least with respect to nominal ownership. If the exemption covers only state taxes, as is true in Texas, for example, the advantage conferred by exemption is so small that on rational considerations it should not induce any noticeable increase in home ownership. With suitable publicity by owners and realtors, however, even this minute advantage may have some effect. But if the exemption covers all property taxes and if the local rates happen to be high, the stimulus should cause a material increase in owner-occupied homes. Methods of legal transfer of title make it relatively easy to acquire the status of a home owner. A leasehold contract may be readily transformed into a contract to purchase, and that is apparently all that is necessary to establish the status as a home owner entitled to the exemption. If suitable promotion were to exploit the exemption in order to make it the cause of a boom, the increase through the boom period might be very large.

Homestead exemption confers an advantage on *persons* and not on *property* as such; the advantage or benefit, if any, attaches to or follows the person, not the property. If we assume stable and normal conditions in the market for residence property, the benefits of tax exemption will accrue to the home owners. This condition will tend to encourage home ownership. Tax exemption would not cause a change in the *total demand for* or *supply of* housing. Exemption may, however, increase the demand for owner-occupied homes. To the extent that this is the case, the demand for tenant-occupied homes will fall.

The argument that present home owners will reap the full advantage offered by tax exemption through capitalization of the advantage, is not valid either "in the long run" or "in the short run," if the condition of the market for residence is normal or stable. But the market may be dynamic, and "in the short run" anything may happen. Should the exemption advantage be so exploited as to generate a boom, the present owner of vacant or improved property may be able to capture all of the capital value of the exemption. In the succeeding recession—a boom by its very nature generates a recession—the first generation of new homestead owners may, along with many purchasers for speculative purposes, lose heavily in having to sell their properties, or in having them fore-

closed. In short, the exemption may become a factor that may be exploited for speculative purposes, with uncertain but probably bad effects upon many home owners. The committee is doubtful if the exemption is in the long run a factor of very considerable importance in encouraging home ownership. More basic economic conditions—the interest rate, the home mortgage credit system, zoning and planning of community development, insecurity of income, inequitable assessments—should be placed ahead of tax exemption in determining the trend of home ownership.

3. *Is Homestead Exemption Equitable?*

Analysis of homestead exemption leads directly and quite far into the question of shifting a fairly large portion of the costs of government from one revenue source to another and, to some extent, from one class of taxpayers to another. Homestead exemption will take away a considerable part of the assessed value base of the property tax structure. If budgets are maintained at existing levels, one of three possible courses of action must be followed: (1) immediate upward adjustment of the assessment of the taxable property remaining after exemption, or the addition of omitted property, or both; (2) increase the rate to be levied on the assessed valuation remaining, without any material change in assessment; (3) leave both assessments and levies where they are, and replace the taxes lost through exemption, by tapping other sources. The conclusion is inescapable that homestead exemption forces consideration of the entire question of tax policies and tax administration, and the people of any state who are enthusiastic about homestead exemption should be certain that the end they seek cannot be realized, unless they are willing to go along in a revenue program which will provide the necessary replacement funds.

Studies of homestead exemption in operation show clearly the unequal effects among individual taxpayers and between different taxing districts. An exemption of, say, $1,500 affects quite unequally an owner of a homestead assessed at $500 and an owner of a homestead assessed at $1,500 or above. If the tax rate is 30 mills, one receives a benefit in tax reduction of $15, and the other of $45. Assuming that economic circumstances make it practical for a large number of home owners to own homes assessed as high as the exemption figure, the exemption law provides a benefit favorable to owners of the better homes. (This differential of advantage, however, is avoided in homestead exemption plans like those in operation in Minnesota and West Virginia.) Exemption will cause a larger reduction in the tax base in districts of high percentage of home ownership than in districts with a low percentage of home ownership. Tax districts which were strong and self-supporting before exemption became operative may be placed in a "weak district" position by reason of the exemption. This situation adds to the already confused scheme of subventions or aids from the central government.

If the revenue needs remain the same after exemption as before, it is obvious that homestead exemption tends to shift a portion of the burden of support of the public service from one group of taxpayers to an-

other—from home owners to owners of business and industrial property, from home owners either to owners of rental residence property or to tenants. If resort is made to the replacement scheme, tax exemption may operate to shift the support of government from those most able to pay to those less able to pay.

The definition of a homestead may cause the exemption to operate quite inequitably as between individuals and groups. Is the exemption to apply only to property used as a home and occupied by the owner? Or is the exemption to apply to productive property, in addition to property in the home? We can better understand this problem when it is applied to assumed conditions. Suppose two adjoining farms, each consisting of 160 acres, are of exactly the same quality of soil, and accordingly are of equal actual and assessed value, as far as productivity of the land is concerned. Assume that the assessed value of the land, exclusive of improvements, is $3,200, or $20 per acre. Assume, further, that the owner and family of Farm No. 1 have an effective desire for a high standard of living, and that they have accordingly built a comfortable home, with other improvements in landscaping, water system, and so on. The owner and family on Farm No. 2, however, have no desires for the amenities of the home and its grounds. The assessed value of the home and its surrounding improvements on Farm No. 1, we shall assume is $1,500, and of the home and surrounding improvements on Farm No. 2 is $500. In the definition of the homestead for tax exemption shall the respective owners and families on these two farms be allowed the same exemption? If a homestead, for exemption purposes, is defined as 160 acres and in a maximum amount of $1,500, then both owners would benefit in the full amount of the exemption. But if the homestead be defined as consisting of the home occupied by the owner and the five acres constituting the homesite, then Farm No. 1 would be accorded the full $1,500 exemption, while Farm No. 2 would be exempted from taxes only in the amount of the value of the home and its surroundings, or $500 for the home and another $100 for five acres (at $20 per acre), or a total exemption of $600.

No proponent of homestead exemption favors exempting productive or income property in towns and cities, under the name of homestead exemption. There would probably be no difficulty in deciding that the urban homestead should be restricted to an area of not more than 1/4 of an acre. To permit the homestead exemption to apply in the country to a large area, say 160 acres, which makes it possible for the exemption to apply to productive property and then to restrict the exemption in towns and cities to residence property only, is to legalize an unreasonable distinction, if not discrimination, between small home owners in the country and in the towns. Suppose we think of an owner of a small grocery store, in a town or city—and there are literally thousands of small-scale business and professional proprietors in any state. Assume that this groceryman lives in his own home, which is assessed for $800. He could not expect to receive the full benefit of the $1,500 exemption. His productive property, store building and stock may be assessed at $2,500, or a total valuation of $3,300, for home and business property. But his

tax exemption is restricted to his home property only.

4. Homestead Exemption and Special Privilege

The taxing power of government should never be used to foster special privilege. Homestead exemption offers a privilege that cannot be extended to all. Any kind of special privilege is objectionable in a democracy. Home owners are likely to vote for tax exemption because it will bring to them a special privilege or benefit. Once adopted there will probably follow promises of extension of the exemption benefits in party platforms and by candidates. The time has come in this country to halt those who promise better schools, more and better highways, higher pensions to more and more people, and so on, and at the same time hold out the pledge to exempt homesteads from taxation and to reduce the unbearable tax burdens resting on the people. Home owners are the most stable citizenship in any community, and more than any other group would be expected to support sound and stable government.

5. "Exemptionitis" a Serious Property Tax Disease

The use of exemption from taxation for the purpose of benefiting certain classes or groups in the population or to encourage the establishment of industries is not a new practice. Ex-soldiers and ex-sailors have in most of the states been beneficiaries of tax exemption. Tax favors and exemptions have been held out as attractions to railroads and manufacturing industries. And the movement continues despite the serious doubt whether tax exemption is of any particular importance in the permanent location of industry. Tax exemption has been granted to religious and charitable and other nonprofit organizations. No one can say whether another legislative act or another court decision will add other zones to this favored territory. Much needed is an acceptable definition of a "religious, charitable, or non-profit organization." Now comes a new and popular demand for exemption of homesteads in behalf of the high purpose of creating a nation of home owners. This new extension of tax exemption will cause rather serious dislocations in state and local revenue systems, and at a time when stability is much to be desired.

"Exemptionitis" is a serious ill of our real estate tax. An extension of exemption to so large a block of property as is represented in owner-occupied homes aggravates the disease. The restoration of real estate tax health requires a major operation to remove the malignant exemption tumor. The committee recommends that we move toward an *exemptionless real estate tax.* We need to destroy the exemption ills we have rather than to fly to homestead exemption and to others we now know not of.

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HAROLD M. GROVES

New Revenues for Municipalities *

THAT the property tax is practically the only source of revenue for municipalities is by no means unanimously accepted. The following article by the editor summarizes some of the available alternatives:

Imagine a city in which the city fathers and the citizens are convinced both that the property tax is overworked and that new services of government are needed in their area. (This should not be a heavy strain on the imagination.) What are the available alternatives?

The city fathers might look first to the possibility of broadening the property tax base. They might express a concern at least for the large and growing exemptions from the property tax. Some of these apply to various forms of personal property and others to real estate used for public or philanthropic or semi-philanthropic or so-called philanthropic purposes. These exemptions are often warranted, but a municipality looking for new revenue sources should regard them with a very critical eye. The exemption of federal property has been growing more and more conspicuous. Some payments in lieu of taxes are now rendered more or less gratuitously but they follow no consistent principle and they are often niggardly.

Another way to broaden the property tax base is by the annexation of suburbs. (This would enlarge both expenditures and the tax base, but frequently there would be a net gain for the tax base.) Between 1930 and 1940, the population of suburban areas grew nearly three times as fast as that of central cities. Differential growth will probably be even greater in the future. The desire to enjoy more land, light, and air is not decreasing, and transportation improvements make commuting easier year by year.

Cities usually provide their suburban areas with many services; some free, some at less than cost, some at actual cost, and very few, if any, at more than cost. Frequently, wealthy suburbs escape very largely from the burden of welfare costs.

Certainly municipalities have every right to protect themselves from exploitation by suburbs. This they can do by charging at least full cost for services rendered outside. Most municipalities have been far too easy on their suburbs and have it in their power to exercise much more pressure than they have applied. Philadelphia goes a step further with its earned income tax, a device used to tax those who work in the city and live outside. Of this, more later.

* *The Municipality* (League of Wisconsin Municipalities), May 1945, pp. 89–90.

Consolidation of cities and suburbs is usually a development eminently desirable from the social point of view. Certainly this is true in those extreme cases where the city has grown to surround its suburb and the latter exists as an independent island in the metropolitan sea. Consolidation ranks high among those fields which are much talked about but in which very little is accomplished. The Wilsonian principle of self-determination works badly in the determination and perpetuation of city boundaries. A state commission of municipal affairs or the judiciary might well be given the power, with some safeguards, to determine proper metropolitan boundaries in the social interest.

A city can enlarge its tax base by promoting industrial development. But this again is no royal road to more revenue. Special tax inducements are suspect on many grounds and they become ineffective if they are offered generally.

Direct Collection for Services

Most city services convey upon citizens benefits which are so diffused and general in character that nothing would be gained by attempting to collect for these services directly rather than through the general property tax. In many cases, such as garbage collection, direct payment on any fair basis would be difficult, and the overhead would be disproportionately high. The main exception seems to be sewage disposal, a service for which direct charges are now collected in many cities, usually through a surcharge on water consumption. This provides at least as equitable a distribution of burden as the general property tax. It enables the city to collect some revenue from tax-exempt property—particularly that owned and operated by other units of government. There is no valid reason why sewage disposal service should be provided "free."

Public Utilities

Many cities have spared the property taxpayer by the successful operation of public service enterprises. Municipal undertakings at present are exempted from federal and state income and state and county property taxes. Where, in addition, a utility has a substantial profit, the city has an especially favorable prospect. According to census data, municipalities receive from public service enterprises an amount equal to about 15 percent of their tax revenue. Some cities receive much more than others from this source.

State and Federal Aids and Shared Taxes

It is well known, of course, that state and federal aids and shared taxes have been increasing in scope. Usually municipalities have not fared too well in these programs. Municipalities are underrepresented in state and federal legislative bodies and this abuse yields slowly, if at all, to attack upon it. That cities are entitled to a better break in shared taxes—particularly motor vehicle taxes—has long been proclaimed and well supported.

However, aids and shared taxes as a way out of the financial wilderness for municipalities encounter limitations. They involve a sacrifice of independence. They involve a circuitous routing of revenues—collected by the state from the municipalities and then returned, frequently only in part, to them. In 1942, New York City's share of total collections from

New York City was about 25 percent. The underrepresentation of cities is a factor which makes for their losing out in this process. Division of burdens and benefits among municipalities is likely to be settled by a balance of political power; it is difficult to find any principle of justice on which to base a division.

It is an open question whether municipalities would not serve their own interests best by opposition to aids except where they are required for equalization purposes—that is, to provide minimum services of government to underprivileged areas.

What the municipalities need is an enlargement of their taxing powers and techniques so that they can spend their own money as their citizens wish and can finance municipal spending programs in a manner locally acceptable.

New Tax Revenues

Municipal supplements to state or federal taxes on incomes, sales, and motor vehicles offer possibilities. These have the objection that they further complicate the tax pattern, but this drawback might be reduced were it feasible to use state or federal administration to determine and collect the local taxes. The usual type of income tax as a municipal revenue source has the disadvantage of great fluctuation in its yield. The development of reserve financing might be the answer to this difficulty but reserves involve thorny problems of their own. An interim committee in Michigan recently recommended that Michigan municipalities be allowed to levy an addition of one half percent to state sales taxes.

By all odds the most promising new tax source for cities is an independent municipal income tax similar to that applied in Philadelphia. Some adaptations to particular environments would be needed.

The Philadelphia tax now applies a 1 percent rate to the earnings of individuals as employees and to the net income of unincorporated businesses and professions (so framed because of conditions peculiar to Pennsylvania). Outside of Pennsylvania, there is no reason why the tax should not apply to corporations. It is collected at the source and applies to income earned in Philadelphia by nonresidents. Interest and other property income should be included, although dividends from corporations that pay the corporate taxes should be exempt.

Such a measure would provide a very broad tax base. Probably a 1 percent rate would ordinarily yield as much revenue as 3 to 5 mills on the property tax base. It would be simpler to administer and much more stable in its yield than the traditional type of net income tax.

This tax would have many advantages over the property tax, sales tax, or gross income tax. It would not, in most cases, be shifted. It would not be regressive. It would not charge the family man more than the single person. It would be in accord with the public conscience which now associates ability to pay with income. It would not be progressive like the traditional income tax (nor regressive like the other alternatives), but it would yield steady and large revenues. The task of equalizing incomes through the tax system would remain with federal and state governments.

A city sales tax has precedents in several cities including New York. In smaller cities, especially, this source of municipal revenue encounters the difficulty that it defeats the trading

advantages of the cities and helps to make shopping in the suburbs attractive. A city gasoline tax, for instance, is an invitation to develop a ring of filling stations around the boundaries of the municipality.

Some cities have used their licensing power to levy business taxes of various types. Thus it is reported that San Diego applies a sort of business poll tax: $10 per company and $1 for each employee on the company's pay roll. A tax on jobs would seem singularly inappropriate when we are witnessing a national campaign to promote employment in the postwar era. In general, city business taxes offer less prospect of revenue and seem otherwise much less desirable than a general personal income tax.

Conclusion

The solution of the municipal finance problem is a matter of general and first-rate public interest. There is much at stake in preserving the vitality of local government and the Emersonian principle of self-reliance on which it rests. Municipalities have only begun the difficult task of convincing the public of these truths.

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CHAPTER 3

SHIFTING AND INCIDENCE

WHETHER taxation is more properly regarded as a branch of economics or one of political science has often been debated. The incidence of taxes, at all events, is mainly economics. Legislatures can pass and repeal acts, but the law of supply and demand usually works outside their jurisdiction and sometimes to defeat their purpose.

Not only is the shifting of taxes a most important aspect of taxation—it is also one that is highly controversial. Differences begin with definitions, continue in the fundamental analysis of how and why shifting occurs, and carry over into the realm of application to particular taxes. New refinements in valuation theory, such as those associated with the idea of monopolistic competition, have added new angles to explore but have not ended the disagreements.

Most of what we know or think we know about shifting is the result of deductive reasoning. We are now for the first time witnessing the extensive use of inductive tools in some areas of economics—notably in business-cycle economics. It is hoped that one day we may have some convincing inductive proof that this or that happens to prices and incomes when a tax is imposed. In the meantime, authors show commendable discretion in their generous use of the adverbs "probably" and "perhaps."

It is impossible to present a detailed analysis of the whole problem of shifting without the use of much graphic presentation and involved logic that cannot here be reproduced. It is hoped that the following selections, covering both the general aspects of shifting and their application to certain major taxes, will provide a fairly adequate general understanding of the problem and give some idea of the territory that cannot be thoroughly explored.

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DAVID WELLS

The Diffusion of Taxes

MAINLY of historical interest, but even now not without proponents, is the theory that all taxes, given time, will be perfectly diffused. They will end as a burden on the consumer in the form of higher prices. A fairly modern version of this diffusion theory is presented by David Ames Wells in his *Theory and Practice of Taxation,* as follows: *

Thus, property is solely produced to supply human wants and desires; and taxes form an important part of the cost of all production, distribution, and consumption, and represent the labour performed in guarding and protecting property at the expense of the State, in all the processes of development and transformation. The State is thus an active and important partner in all production. Without its assistance and protection, production would be impeded or wholly arrested. The soldier or policeman guards, while the citizen performs his labour in safety. As a partner in all the forms of production and business, the State must pay its expenses—i.e., its agents, for their services; and its only means of paying are through its receipts from taxation. Taxes, then, are clearly items of expense in all business, the same as rent, fuel, cost of material, light, labour, waste, insurance, clerical service, advertising, expressage, freight, and the like, and on business principles they find their place on the pages of profit and loss; and, like all other expenses which enter into the cost of production, must finally be sustained by those who gratify their wants or desires by consumption. Production is only a means, and consumption is the end, and the consumer must pay in the end all the expenses of production. Every dealer in domestic or imported merchandise keeps on hand, at all times, upon his shelves, a stock of different and accumulated taxes—customs, internal revenue, State, school, and municipal —with his goods; and when we buy and carry away an article from any store or shop, we buy and carry away with it the accompanying and inherential taxes.

Any primary taxpayer, who does not ultimately consume the thing taxed, and who does not include the tax in the price of the taxed property or its products, must literally throw away his money and must soon become bankrupt and disappear as a competitor; and accordingly the tax advancer will add the tax in

* From *Theory and Practice of Taxation,* by David Ames Wells, copyright, 1900, by D. Appleton and Company, 1927, by Marietta H. Allcroft, reprinted by permission of D. Appleton-Century Company, Inc., pp. 583–586.

his prices if he understands simple addition. How rapidly bankruptcy would befall dealers in imported goods, wares, and merchandise in the United States who did not strictly observe this rule will be realized when one remembers that the average tax imposed by its Government (in 1896) on all dutiable imports is in excess of fifty per cent.

When Dr. Franklin was asked by a committee of the English House of Commons, prior to the American Revolution, if the province of Pennsylvania did not practically relieve farmers and other landowners from taxation, and at the same time impose a heavy tax on merchants, to the injury of British trade, he answered that "if such special tax was imposed, the merchants were experts with their pens, and added the tax to the price of their goods, and thus made the farmers and all landowners pay their part of the tax as consumers."

Taxes uniformly levied on all the subjects of taxation, and which are not so excessive as to become a prohibition on the use of the thing taxed, become, therefore, a part of the cost of all production, distribution, and consumption, and diffuse and equate themselves by natural laws in the same manner and in the same minute degree as all other elements that constitute the expenses of production. We produce to consume and consume to produce, and the cost of consumption, including taxes, enters into the cost of production, and the cost of production, including taxes, enters into the cost of consumption, and thus taxes levied uniformly on things of the same class, by the laws of competition, supply, and demand, and the all-pervading mediums of labour, will be distributed, percussed, and repercussed to a remote degree, until they finally fall upon every person, not in proportion to his consumption of a given article, but in the proportion his consumption bears to the aggregate consumption of the taxed community.

A great capitalist, like Mr. Astor, bears no greater burden of taxation (and can not be made to bear more by any laws that can be properly termed tax laws) than the proportion which his aggregate individual consumption bears to the aggregate individual consumption of all others in his circuit of immediate competition; and as to his other taxes, he is a mere tax collector, or conduit, conducting taxes from his tenants or borrowers to the State or city treasury. A whisky distiller is a tax conduit, or tax collector, and sells more taxes than the original cost of whisky, as finds proof and illustration in the fact that the United States imposes a tax of one dollar and ten cents per gallon on proof whisky which its manufacturer would be very glad to sell free of tax for an average of thirteen cents per gallon. The tax, furthermore, is required to be laid before the whisky can be removed from the distillery or bonded warehouse and allowed to become an article of merchandise. Tobacco in like manner can not go into consumption till the tax is paid. In Great Britain, where all tobacco consumed is imported, for every 3*d.* paid by the consumer, 2.5*d.* represents customs duties or taxes. In Russia it is estimated that the Government annually requires of its peasant producers one third the market value of their entire crop of cereals in payment of their taxes, and fixes the time of collecting the same in the autumn, when the peasant sells sufficient of his grain (mainly for exportation), and with the purchase money

meets the demands of the tax collector. Can it be doubted that the sums thus extorted enter into and form an essential part of the cost of the entire crop or product of the land? It is, therefore, immaterial where the process of manufacture takes place; the citizens of a State pay in proportion to the quantity which they consume. The traveller who stops at one of the great city hotels can not avoid reimbursing the owner for the tax he primarily pays on the property, and the owner, in respect to the taxation of his hotel property, is but a great effective real-estate and diffused tax collector. Again, the farmer charges taxes in the price of his products; the labourer, in his wages; the clergyman, in his salary; the lender, in the interest he receives; the lawyer, in his fees; and the manufacturer, in his goods.

The American Bible Society is always in part loaded with the whisky and tobacco taxes paid by the printers, paper-makers, and bookbinders, or by the producers of articles consumed by these mechanics, and reflected and embodied in their wages and the products of their labour according to the degree of absence of competition from fellow-mechanics who abstain from the use of these and other taxed articles.

These conclusions respecting the diffusion of taxes may be said to be universally accepted by economists so far as they relate to the results of production before they reach the hands of the final consumers; but they are not accepted by many, as Mr. Henry George has recently expressed it, in respect to taxes on special profits or advantages on things of which the supply is strictly limited, or of wealth in the hands of final consumers, or in the course of distribution by gift, and finally in respect to taxes on land. But a little examination would seem to show that all these exceptions are of the kind that are said to prove the rule. *Special profits* and advantages in this age of quick diffusion of knowledge and intense competition are exceedingly ephemeral, and are mainly confined to results which the State with a view of encouraging removes for a limited time from the natural laws of competition by granting patents, copyrights, and franchises. Of things which are strictly limited in respect to supply, what and where are they? Only a very few can be specified: ivory, Peruvian guano, whalebone, ambergris, and the pelts of the fur seal. Of wealth in the process of transmission, or in the hands of final consumers, it is not *tangible* wealth unless it is *tangible* property, which conforms under any correct system of taxation to the principles of taxation; and if any one advocates the taxation of the right to receive property which has already been taxed, he in effect advocates a double exaction of one and the same thing. If it be asked, Will an income tax on a person retired from business be diffused? the answer, beyond question, must be in the affirmative, if the tax is uniform on all persons and on all amounts, and is absolutely collected in minute sums. Would any one pay the same price for a railroad bond which is subject to an income tax as he would for it if it was free from tax? If one's land is taxed, either in the form of rent or income, will not the tenant have the burden primarily thrown upon him? And, finally, will not the consumer of the tenant's goods pay through or by reason of such consumption?

HAROLD M. GROVES

Summary of John A. Hobson's "Functional Approach to Taxation"

A QUITE different approach is that of John A. Hobson, who divided income into two elements, surplus and cost, the former amenable to tax burdens, the latter compelled to pass them on. Hobson's theory is one of tax policy as well as of incidence. It has been summarized by the editor as follows: *

One of the early proponents of what is now called the "functional" approach to economic problems was John A. Hobson. He contended that a sound tax system must not impair essential incentives to production or useful elements of consumption.[1] To discover the really taxable elements of income, those with a true "ability to bear," the origins or sources of income and the uses to which the income is applied must thus be examined. Hobson breaks down the concept of income into two parts: economically necessary payments for the use of factors of production (costs) and unnecessary or excessive payments (surplus). "Standard" wages constitute a necessary "cost," which has practically no ability to bear taxes. A minimum rate of interest as a return on invested capital is also a necessary payment, in this case to induce the saving classes to withhold enough of their spending power to supply such capital. A certain portion of profits is also necessary to stimulate initiative and energy for a thriving and growing private business.

Everything above these costs Hobson labels surplus income and designates as a proper object for taxation. Although the separation of costs and surplus is a difficult task and a considerable margin of error is inevitable, these limitations do not invalidate the principle. Hobson proposes his analysis as a theory of incidence as well as one of conservation. Taxes on costs will be shifted to surplus in any event, but the shifting process will involve waste and damage to production, extortion from consumers, and deception of the public as to the incidence of the levies. The surplus incomes can bear taxes without any shifting. Thus, economic rent could be taxed to the point of near-confiscation, since the land could not be destroyed to avoid taxation. A tax on land appraised at its most profit-

[1] J. A. Hobson, *Taxation in the New State* (New York: Harcourt, Brace and Company, Inc., 1920), p. 12.

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able use would constitute a strong incentive to use the land most advantageously. Such use would be necessitated by the compulsion of meeting the tax bill.

Profits are packed with surplus because of the propensity of business to avoid competition through monopolistic practices and combinations. Monopolies set prices at the point of maximum net profits. This point would not be changed by the imposition of taxes on profits and, if it were, this would only indicate that insufficient skill and caution had been exercised in the imposition of the levies. It is suggested that a portion of reinvested corporate earnings might be exempted from taxation in the interest of adequate capital. But such exemptions would be limited in amount and confined to vital industries after a thorough scrutiny by the Income Tax Commissioners.

The doubtful feasibility of earmarking surplus, except for economic rent, is recognized, and Hobson would rely heavily on the general income tax as a first means of reaching income possessing real "ability to pay." This tax would make no distinctions, or at least not many nor very elaborate ones, on the basis of income sources, but it would recognize the number of dependents that must get their support from the income. Income taxes would be supplemented by levies on estates, a surplus peculiarly fitted for taxation. The death taxes would reduce fiscal dependence upon the income tax and allow the latter to be kept within limits that would not obstruct the incentives to earn and save. Luxury consumption taxes might also have a legitimate place in a functional scheme of taxation, but most indirect taxes are ruled out as bearing too heavily upon those classes whose maintenance is a necessary social cost.

Thus Hobson conceived a scheme of taxation aimed at those elements of income which could be taxed without injuring the efficiency of production and subsequent decent living standards. His goal was revenue at no cost to economic efficiency and progress. His was a pioneering work on the subject of taxation and incentives and, although some of his conclusions are open to question, he offered a great deal of sound thinking on the subject, insufficiently recognized by many later public-finance writers.

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CARL SHOUP

Capitalization and Shifting of the Property Tax

ONE form of shifting, known as capitalization, covers the case where the present owner of a commodity or a capital good absorbs the tax which its future owner must pay. When the commodity or capital good is sold, all or part of the predictable future taxes on it are discounted by the purchaser. The application of this doctrine to property taxes is discussed in the following selection by Carl Shoup: *

Theory of Capitalization

Illustration of Capitalization

The value of a piece of property depends upon an estimate of its future net income (viz., the value, expressed in money, of the services it will render) and the rate at which the income is capitalized. For example, one person thinks a certain property will yield a net income of $1,000 a year forever, and is willing to capitalize at 5 per cent; therefore, he bids $20,000 for the property. Another estimates the net income at only $900, but is willing to use a 4 per cent rate in capitalizing, and hence bids $22,500.

If a fear develops in the mind of the prospective purchaser, that the net income from the property will be diminished by an added amount of tax to be collected sometime in the future, he will of course be impelled to revise his bid downward by the amount of the prospective increase in tax—the amount, that is, discounted to a present value by the application of the particular rate of interest that he associates with this property. Thus if he thinks that a year from now the property will be subject to a special, once-for-all increased tax payment of $100, his bid will drop by the present value of $100. In terms of the example above, the highest bidder will lower his offer by $100 discounted for one year at 4 per cent, that is, by roughly $96; hence he will offer, not $22,500 for the property, but $22,404. In the more usual case he foresees, not a single once-for-all increased tax payment, but a series of such increased payments stretching far into the future. For instance, he may think that the property will have to bear an increased tax of $100 next year, $100 the year following, and so on forever, as will be the case with land if he expects a permanent rise in the tax rate, or a permanent change in the assessed valuation. He will then have to subtract from his former bid price, not merely the present value of next year's added tax burden, but also the

* "Capitalization and Shifting of the Property Tax," *Property Taxes,* Chap. 13. Reprinted by permission of the Tax Institute, New York.

present value of the added burden of the second year, of the third year, and so on forever. In that case he lowers his bid price, not by $96, but by $2,500, since this is the present value of a series of payments of $100 a year forever with interest at 4 per cent. Thus his bid price drops from $22,500 to $20,000.

This particular illustration assumes, of course, that none of the tax can be shifted to anyone else; it also presupposes that the government does not spend the tax revenue in a way that either adds to or subtracts from the net-income-producing power of the property, or lowers the rate at which the net income is capitalized.

It has been implied above that the value of chief interest is the value to the prospective or possible purchaser whose bid is the highest—or to put it the other way around, no attention is paid to the price at which the existing owner is willing to sell the property. But it may be useful to think of capitalization of the tax in terms of the owner's own offer, or withholding, price. Thus if he estimates the income at $900 but is willing to capitalize at 3 per cent, his own offer price is $30,000, before knowledge of the tax increase. He also uses a 3 per cent rate in capitalizing the tax increase; thus his offer price is lowered by $3,333 to $26,667. We have seen that the highest price bid by a prospective purchaser dropped by $2,500, from $22,500 to $20,000. The property remains in the hands of the existing owner, under these conditions, but which is the more significant thing to say—that the tax has been capitalized into a decrease in value of $2,500 or $3,333? Probably one or the other will be the better, according to the type of problem being analyzed; the chief necessity will be to make clear, in any particular discussion, which one is referred to.

The aspect of this phenomenon of capitalization that has attracted most interest is the situation of the person who buys the property in the light of the prospective increase in tax. If the increase does materialize and if it does not itself affect the rate of capitalization (a matter to be discussed below) he still has suffered no loss in money value of his holdings thereby; had there never been any prospect and materializing of the increase in tax, he would have paid a correspondingly higher price for the property. Therefore, so far as loss in money value of property is concerned, he is in no position later to complain that this part of the tax burdens him unfairly—a conclusion that holds no matter how large this part may be.[1] The same conclusion (no loss in money value) would hold for the rest of the tax—the old tax—except, again, as it may itself have affected the rate of capitalization.

Some interesting corollaries have been drawn from this conclusion, three of them being of special importance:

1. The tax in question gives the new owner no claim to exemption from any new general tax designed to strike all persons, property, or incomes;

2. A subsequent lowering or repeal of the tax in question would be an undeserved gift by the government to those who had capitalized

[1] For the early literature on tax capitalization, which was especially concerned with this point, see Edwin R. A. Seligman, *The Shifting and Incidence of Taxation* (5th ed., revised, New York: Columbia University Press, 1927), pp. 174–83.

the tax when purchasing[2] (for some pieces of property such a lowering of tax may result from a reform of assessments that lowers some property values relative to others—an illustration of the general tendency of past tax capitalization to induce us to accept the present situation, though the argument is, of course, not necessarily the decisive one);

3. The owner at the time that the prospect of an added tax develops may thereby lose in value far more than one year's tax—may indeed suffer a loss far heavier than any that the legislator would be willing to impose on him by some direct, personal tax.[3]

Effect of Tax on Net Interest Rate

Up to this point it has been assumed that the prospective tax does not itself alter the net rate of return that purchasers of the taxed capital demand—or generally, the rate of interest that investors in the taxed field demand. If the prospective tax is very limited in scope this assumption is reasonable. But if it extends over a wide field, even though not over the whole field, it is likely to have some effect on both the volume and direction of flow of investable funds.[4] The present discussion cannot do more than barely touch on the effect of the property tax on the rate of interest, but a sample of the kind of analysis will illustrate the point. Capital will tend to flow from the taxed field to the untaxed field, but users of funds—speaking loosely, borrowers—operating in the untaxed field may not be able to absorb the additional capital and still offer as high a rate of return as before. Thus the rate of interest in the untaxed field would tend to fall. As to the taxed field, the tendency of capital to move away from it will tend to raise the rate of interest that the borrowers must pay there (compared to the rate they would pay without the tax).[5] This borrower's rate of interest must be distinguished from the lender's rate of interest, the lender's rate being after deduction of tax. If the volume of investable funds tends to be restricted as the lender's rate declines, a new equilibrium will be reached at some point where (1) the borrowers in the untaxed field are paying a lower rate of interest than they would otherwise have paid,[6] (2) borrowers in the taxed field are paying a higher rate of interest than they would otherwise have paid, (3) lenders in the taxed field are getting, after tax, the same return as lenders in the untaxed field, and (4) lenders in both fields are therefore getting a smaller return than they would otherwise have received.[7] The significance of these conclusions for the capitalization

[2] See John Stuart Mill, *Principles of Political Economy* (Ashley ed.), pp. 820–21; Alfred Marshall, *Official Papers*, pp. 337, 352–54.

[3] Mill, *op. cit.*, p. 810.

[4] M. Slade Kendrick, "The Incidence and Effects of Taxation; Some Theoretical Aspects," *American Economic Review*, XXVII (Dec. 1937), pp. 730–31.

[5] But lower than the rate they would have to pay if the tax was so narrow in scope as not to affect the lender's rate of interest.

[6] In this analysis, "untaxed" means the same as "non-taxed"—i.e., it does not imply that the property in question used to be taxed.

[7] For instance, if the rate of interest is 4 per cent and if a special 20 per cent income tax imposed over a large part of the investment field forces the borrower's rate of interest in the taxed field up to 4.5 per cent, it follows that lender's rate of interest in that field is now 3.6 per cent and, in the untaxed field, both borrower's and lender's rates are likewise 3.6 per cent (hence capital already fixed in the untaxed field tends to rise in value).

theory is that the interest rate at which the income is capitalized is reduced by the tax itself, and since the lower the interest rate the higher the value, the property does not drop in value as much as it would if the tax had not lowered the rate. In other words, the tax, if spread over a wide enough field, exercises two counteracting forces on the value of property. By lowering the lender's rate of interest (and it is this rate that is used in capitalizing the tax) it tends to increase all property values, and the net result is an increase as concerns the untaxed property. By lowering the yield of the taxed property it tends to lower its value, and the net result is a lowering of the value of that property.[8]

In this case there has been some uncertainty how to use the term "tax capitalization"—whether to use it to include the effect of the tax on the interest rate.[9] At this point it will be used to refer to the combined effect, expressed in terms of capital value, on the interest rate and on the net income from the property; but this is done in full recognition of the possibility that in many analyses—perhaps indeed in most—it will be convenient to isolate the counteracting forces more sharply by restricting "capitalization" to mean the change in value that would have occurred if the tax measure in question had affected only the income from the property and not the lender's interest rate. (In fact, in the second part of the present discussion the term will be used in this narrower sense.)

Similarly, where the analysis has postulated a universal tax on property or its income, so that there is no tax-free property available, there has been some doubt whether "capitalization" should refer also to the effect, if any, on the lender's rate of interest. Incidentally, the only way in which it can be shown that a general tax levied equally on all investments is not capitalized is to define capitalization to include the effect on the lender's rate of interest; for the only case in which capital values will be unaffected by the general tax is when this tax lowers the lender's rate of interest by just enough to offset the cut in the income caused by the same tax. The odds seem to be decidedly against a lowering of exactly this amount, especially when the use to which the government puts the revenue is taken into account.[10]

[8] Actually the problem is much more complex than this sample of analysis might indicate, if only because it ignores the use made by the government of the money. [This analysis does not cover the case brought up by Professor Harry Gunnison Brown in the discussion before the American Economic Association subsequent to the delivery of this paper. That case postulated, not an additional tax levied on both land and improvements within a certain field as in the text above, but an additional tax on land with a corresponding reduction of tax on improvements. In that case, as Professor Brown pointed out, the tendency would be for the lender's rate of interest in the improvements field (and hence also in the land field) to increase, with a corresponding downward pressure on the value of land—a pressure supplementing the one caused by the decrease in land income brought about by the added land tax.]

[9] Seligman, *The Shifting and Incidence of Taxation,* p. 218; compare his later views, somewhat modified, in "The Effects of Taxation," *Political Science Quarterly,* March 1923, pp. 3, 6, 9–10; and Kendrick, *loc. cit.,* pp. 729–32. Griziotti defines capitalization ("amortization") in the wider sense. See Benvenuto Griziotti, "Teoria dell'ammortamento delle imposte e sue applicazioni," *Giornale degli Economisti,* Jan. 1918, pp. 15–19.

[10] For an analysis of three possibilities with respect to the use of the revenues and their relation to tax capitalization, see Luigi

Other Points with Respect to Capitalization

Before concluding this first part of the paper, attention may be called briefly to the other chief points that have been developed with respect to capitalization of the property tax:

1. A property tax at a given rate levied on capital value rather than income will, so far as it forces assessed property values down, automatically lighten the burden it imposes in terms of dollars of tax. Capitalization cannot be expressed in terms of a rate of tax on the capital value before tax.[11] But this factor is presumably offset, in principle, at least, by the setting of a tax rate that is higher than it would be if it did have the old capital values to rest upon.

2. Since the prospect of the change in amount of tax must always be somewhat uncertain, some capitalization, in one direction or the other, may be occurring rather frequently, perhaps almost continuously, as expectations change; indeed, capitalization is one of the examples of tax burden that can occur merely from the prospect of a tax and even though no such tax ever materializes. It has even been argued that one who buys into one type of investment that is lightly, or heavily, taxed compared to others ought to—or does—consider that at some uncertain future date this difference will be lessened by an increase, or decrease, in tax.[12]

3. Although capitalization and shifting cannot both occur with respect to the same segment of tax on the same owner, it is of course possible for one segment of the tax to be capitalized and another segment shifted; and it is possible for the shifted tax to be capitalized by the owner of the property to which it is shifted.

4. The rate at which the income of a property is capitalized will differ, at a given time and place, with the type of property under consideration, even disregarding differences in the length of term of investment. A prospective tax on all these properties will or will not reduce their values in varying degrees, rather than by a uniform percentage, depending on (1) whether the rates of capitalization differ because of a difference that is proportional to the income (e.g., difference in risk) or, instead, because of a factor that is, within a range, independent of the income (e.g., a certain lump-sum value put on the satisfaction of owning one's own home) and (2) whether the tax is imposed on income or capital value.[13]

5. The use made of the tax money makes a difference. If the revenue

Einaudi, "Intorno al Concetto di Reddito Imponibile," *Memorie della Reale Accademia delle Scienze di Torino, Serie Seconda, LXIII* (1913). *Scienze Morali, Storiche e Filalogiche,* note 1, pp. 287–89.

[11] For this point, and a general statement of the formulas applicable in tax capitalization, see Jens P. Jensen, *Property Taxation in the United States,* pp. 63–68, 329–30.

[12] See sources cited in Griziotti, *loc. cit.,* pp. 25–26.

[13] Jens P. Jensen, "Tax Capitalization," *Bulletin of the National Tax Association,* XXIII (Nov. 1937), p. 53, and sources there cited. To supplement Professor Jensen's analysis on a minor point, it may be added that in the case that he postulates of desire for home ownership, a tax on an income basis (as contrasted with capital-value basis) would lower the value of the home property by a smaller percentage than it would the value of some other property, the values of the two properties being equal before the tax.

is spent in a way that increases the net money income of the taxpayer's property before the tax (either by increasing its gross income or decreasing its expenses), or if the government distributes non-monetary income in an amount and quality that induces capitalization at a lower rate,[14] the result may conceivably be no decrease in the money value of the taxed property. Various other cases, ranging from some indeterminate increase in value down to the decrease postulated when expenditures yield no benefit, may be imagined.

6. Although the present paper is restricted to capitalization under the property tax, it may be recalled that many other taxes can be capitalized.[15] The proper method of integrating an individual income tax and a corporation income tax, including the treatment of capital gains and stock dividends, depends in part on assumptions, explicit or implicit, with respect to possible capitalization of the income tax on corporations through changes in prices of corporate shares.

Suggestions for Further Exploration

It is evident that capitalization of the property tax has been studied in many of its aspects, over a long period of time. What are some of the next steps in research on this topic that may be fruitful? In its broader aspects the problem covers the effect of taxation on rates of interest; but the points suggested below are confined to tax capitalization in the narrower sense of the term.

In general, it seems that at least three types of research are needed: first, a further development of the theory; second, inductive studies designed both to test the degree to which these generalizations are valid and to raise additional questions; and third, attempts to make explicit the implications that such findings carry for tax policy in the United States. The present discussion will consider in detail only the first type.

Further Development of Theory

In further development of the theory, it may prove useful to examine some of the following points:

1. The degree to which capitalization of the property tax may occur with respect to improvements (as distinguished from land) under various assumptions of durability and time of renewal. This may lead to some interesting connections with the study of business cycles in general and construction cycles in particular. Tax capitalization is essentially an influence exercised by unexpected tax changes on the value of fixed capital. From this it might seem to follow that the degree of depreciation in value would depend on the durability of the capital in question, the degree of fixity, or, in still other words, the length of time that is to elapse before the owner's capital is to be returned to him. This is not quite the case, however. If, for example, in a community with a steady demand

[14] Jensen, *loc. cit.*, p. 55. See also the discussion by Simeon E. Leland, "The Real Estate Tax: Capitalization and Benefit," and Edwin H. Spengler, "The Real Estate Tax: Capitalization and Benefit—A Reply" in *Bulletin of the National Tax Association*, XVIII (May 1933), pp. 227–35; K. M. Williamson, "The Taxation of Real Estate: A Survey of Recent Discussion," *Quarterly Journal of Economics*, Nov. 1933, pp. 96–128; Twentieth Century Fund, *Facing the Tax Problem*, pp. 550–51.

[15] Twentieth Century Fund, *Facing the Tax Problem*, pp. 244–45; Griziotto, *loc. cit.*, pp. 4, 7 (wages tax shifted to employers), pp. 8–10 (personal income tax causing increases in rate of interest).

for dwelling accommodations, one twentieth of the dwellings were to wear out completely each year, then each year new dwellings to the amount of one-twentieth of the existing stock would have to be constructed. If the property tax on dwellings (that is, on the improvements that are renewed each 20 years—not the land) were suddenly increased at the start of a certain year, the usual amount of replacement would presumably not occur, the demand not being completely inelastic. On the supposition that, if only one-half the usual amount of replacement occurs, rentals will strengthen enough to cover the increased tax (constant costs being assumed within the range in question), no drop in the value of the old dwellings need occur, even though the life span of each is 20 years. But if, instead, all the dwellings wear out in the same year and all are replaced at once, there is, in 19 years out of the 20, no way to alter the supply immediately by a refusal to build what would otherwise have been built, since nothing would have been built anyway. An unexpected increase in tax occurring in any one of these years will affect the capital values of the existing improvements; the value of each dwelling will decrease by the capitalization of the prospective taxes up to the year when replacement becomes necessary. On the other hand, if the unexpected tax increase occurs at the start of the year in which the complete replacement was to have been made, the supply can be restricted within a short time, or, to put it another way, the fixed capital values subject to infringement are by that time almost zero.

Obviously, the actual situation does not correspond either to the extreme of uniform annual replacement, or to the extreme of periodical complete replacement; and replacement is often supplemented by additional construction. But the existence of construction cycles indicates that the latter extreme—periodical complete replacement—is approached closely enough to make of interest a study that would examine unexpected onerous increases in the property tax on dwellings in the light of the point along that cycle at which they do or might occur.

2. The result obtained under capitalization of the tax is measured, in principle, by comparing what happens to property values under the change in the property tax with what would happen to those values without the change in the property tax; but, under this "without-change-in-property-tax" status (which is a sort of base line for measurement), there are several combinations possible and most of the analyses have been predicated on only two of them. Generally, it seems to have been assumed that if the change in the property tax did not occur, there would be a corresponding lack of change in governmental expenditures either of a kind that would be of no measurable importance for the property in question or of a kind that would presumably benefit the property. A third assumption, more realistic in many instances, is that if the change in the property tax did not occur, a corresponding change would be made in some other tax or taxes. Thus the comparison might be, for example, between (1) the change in property values that would occur if the city of Philadelphia increased the property tax and (2) the change in property values that would occur if it instead imposed an income tax (as has recently been the case). Further illustrations may be furnished by

the recent measures granting homestead exemptions with accompanying changes in other taxes. It is not implied here that one or the other tax measure is preferable or even that in these specific cases the differences could be measured with any useful degree of accuracy; the inference to be drawn is, rather, that this type of problem needs to be studied, at least in its general aspects. If, for example, we postulate that the alternative to a change in the property tax is a change in some other tax, and if, under the change in the property tax, a certain piece of property would be worth \$10,000 while under the change in tax X it would be worth \$11,000 and under the change in tax Y, \$12,000, may we then say that capitalization of the property tax is effective only to the extent of \$1,000 or \$2,000, as the case may be, or should we continue to measure capitalization by appeal to a third situation that has been ruled out by the basic assumption? In part, this question poses merely a problem of convenience in terminology, but raising it may induce helpful comparisons. Some approaches have already been made to the alternative-tax type of comparison,[16] but most of the work lies ahead. (Of course, the analyst may abstract from every change except the change in the property tax,[17] but he must then state clearly that his investigation has stopped midway, so to speak, and at that stage gives the legislator little if anything on which to base a decision. To be sure, an analysis that assumes other things equal may be useful even for policy purposes if the tax change in question is small in amount or scope; but not otherwise.)

3. The capitalization of the property tax on intangible personal property, particularly shares of common and preferred stocks and long-term bonds, offers some peculiar problems that may need special attention, especially since the degree of capitalization may depend partly on the extent to which the prospective purchaser thinks he can evade the tax.

4. The fact that market rates of interest commonly differ according to the length of the investment period will make the risk of capitalization a more serious one for some investments than for others. At the present time, when long-term rates are much higher than short-term rates, the risk is more serious for long-term investments. These remarks assume that the tax in question is one on capital value. If it is one on net income (not including, therefore, return of capital), the risk is more serious for long-term investments even if interest rates are the same for all terms.

5. In studies that are designed to indicate the amount of taxation, direct and indirect, resting on persons at each of several specified income levels, the problem of whether to al-

[16] Harry Gunnison Brown, *The Economics of Taxation*, pp. 239–41.

[17] "Is it not competent to the 'mechanics of industry' to treat superposed disturbances independently and one at a time? If a person wears high heels, may we not estimate the elevation due to that cause without putting him on a hill?" F. Y. Edgeworth, *Papers Relating to Political Economy*, II, 70. But Edgeworth adds, "If indeed there is some connection between the artificial elongation and the position of the wearer, it may be proper to note this." Since a change in the property tax necessarily implies a change of corresponding magnitude in other revenues, in expenditures, in borrowing, or in cash balances (or a combination of these), it seems not only proper, but highly desirable, to take account of these changes, once the analysis of the property tax change alone has been fairly well developed.

low for capitalization of the property tax, and, if so, how, is an extremely perplexing one.[18]

Inductive Studies

As to inductive studies of property transfer, changes in tax rates, and other relevant phenomena, the difficulties are great, owing to the expense of obtaining even a small amount of data and the problem of interpreting them after they are gathered, but it may be practicable to study fairly small areas, covering a time period long enough to make the results significant.[19]

[18] Mabel Newcomer, "Estimate of the Tax Burden on Different Income Classes," *Studies in Current Tax Problems* (Twentieth Century Fund), pp. 12–13, 22, 33, 35, 40.

[19] The most important study of this kind of which I am aware is that made by Edwin H. Spengler, in "Memorandum Number 4: Turnover of Title to Real Property in New York," in *Report of the New York State Commission for the Revision of the Tax Laws*, Feb. 15, 1932.

Application of Findings to Problems of Policy

Finally, the application of the findings, both from generalizations and from specific studies, to particular problems of policy seems, for the near future at least, to be most important with respect to prospective decreases in the property tax rather than increases. Homestead exemptions are a case in point. In reports on revision of particular state and local tax systems, it seems reasonable to expect that the problems created by capitalization of the property tax will receive enough attention both to utilize past findings and to suggest further topics and methods for future research.[20]

[20] See, in the *Report* cited in the preceding note, pp. 37, 43, 46–47, 89–90, 99–100, 127–31, for an example of the application of research on this matter to a particular problem of policy.

24

MARION HAMILTON GILLIM

Summary of Conflicting Views Concerning the Incidence of a General Income Tax

THE incidence of taxation is a controversial subject upon which economists are by no means agreed. This can readily be seen in the various views on the application of incidence theory to the income tax. These views, including differences of definition, have been excellently summarized by Marion Hamilton Gillim as follows: *

* Reprinted from Marion Hamilton Gillim, *The Incidence of Excess Profits Taxation*, pp. 11–34. No. 514 of the Studies in History, Economics, and Public Law. Copyright 1945 by Columbia University Press.

Numerous economists have written on the incidence of the general income tax, but only the opinions of three will be discussed here. These three are Edwin R. A. Seligman and Antonio de Viti de Marco who represented opposite approaches, and Duncan Black who presented a theory which, besides containing much original thought, synthesized the two opposing theories.

1. *Edwin R. A. Seligman*

Seligman expressed the view which probably has been accepted by most economists in his statement that

> a general tax on net profits can never be shifted. If profits represent the surplus above cost of production, a general tax on this surplus cannot influence the cost of production. Price cannot be altered, and the interests of the consumer cannot be affected. It is the producer who bears the tax, both immediately and ultimately.[2]

All economic thought on incidence, however, has not been in agreement with this statement. Both De Viti de Marco and Duncan Black presented convincing argument to demonstrate that a general tax levied on net income often is shifted and that this shifting is manifested by a change in the prices which existed prior to the levying of the tax. This apparent contradiction in conclusions can be resolved, to some extent, by an examination of these authors' definitions and assumptions, which are not uniform.

The economic processes involved in the shifting of an indirect tax were described by Seligman. To him the shifting of a tax that could be shifted was "primarily a question of prices." [3] The rise in price, which signifies the forward shifting of a tax on producers, will, if shifting occurs, come about through increased cost and a resulting contraction of supply. Seligman described the shifting of an indirect tax levied on the production of a commodity as follows: [4]

> Since the tax is an addition to the cost of producing the article, they [the producers] will seek to recompense themselves by raising the price. Unless they succeed in this, their profits will be curtailed and the production of the article will diminish. For one of two results must ensue: either producers will gradually transfer their capital to untaxed industries, or, even if the transfer of capital is impossible because it is firmly fixed in the industry, production will be curtailed by the crowding out of those who were previously on the very margin of profitable production, while the tax will prevent the influx of any new capital. In either case, then, in the long run, the supply will decrease; and this diminution, provided the commodity continue to be produced at all, will involve an increase of price. The consumer will, therefore, bear the burden of the tax.

One of two occurrences, then, is necessary if a tax on the production of a commodity is to be shifted: first, the transfer of capital to other fields, or second, the curtailment of supply with the elimination of that portion of the product which was on the margin.

Seligman showed that a general income tax will not have either of the above effects. There will be no transfer of capital unless it can be

[2] Edwin R. A. Seligman, *The Shifting and Incidence of Taxation* (5th ed., revised; New York: Columbia University Press, 1926), p. 362.

[3] *Ibid.*, p. 217.

[4] *Ibid.*, p. 218.

invested more profitably. When a general income tax reduces the profitableness of capital in one employment, however, it reduces the returns to that capital in all its uses, for no field remains where the income will be free from tax. If, prior to the tax, both capital and entrepreneurial ability are being used most effectively, then a general income tax cannot disturb the allocation of these productive factors. Although the tax will reduce profits, it will not alter the relative profitableness of various businesses.[5]

Neither can a general income tax bring about any reduction of supply through the elimination of marginal producers, who pay no tax. Seligman recalled the neo-classical explanation of price determination according to which the cost of producing and of bringing to market the most expensive portion of the supply will tend to equal the market price. Profit, which to Seligman was the difference between price or the cost of production of the most expensive part of the supply and the actual cost of production, will not accrue on the production of the marginal product. A tax levied on profits cannot touch the marginal producer, for he makes no profits. Yet this marginal producer is contributing to the supply which together with the demand determines the market price. If the tax does not affect him, it cannot deter him from bringing to market that product the cost of which is just covered by the price. If the tax does not affect production at the margin, it cannot enter into the determination of price.[6] This reasoning applies only to a competitive situation where the price, determined in the market through the interaction of supply and demand, will approximate the marginal cost of production.

When the tax falls on monopoly profits, however, Seligman reached the same conclusion that an income tax cannot be shifted to the consumer. The argument in this case is as follows: It is assumed that the monopolist will have arranged to produce that output which allows him the maximum profit. He will find that, after his income has been reduced by the tax on profits, the income which remains to him will still be greatest for that same output which maximized his profit before the tax. If the supply is unaltered, then the price will not change, and the entire burden of the tax must fall on the monopolist.[7]

2. *Antonio de Viti de Marco*

The above theory of incidence is the one which has gained acceptance, with few reservations, among most students of public finance. But the keen criticisms brought by Antonio de Viti de Marco against this theory cannot be ignored in any review of the theory of incidence. De Viti de Marco made his greatest contribution to the study of incidence through his emphasis of the important effects which a tax may produce on demand. One aspect of the more orthodox theory of which he was especially critical is the practice of observing all effects of taxation, along with all other economic problems, from the producer's point of view. This producer whose reactions to a tax usually are studied is the one on whom the tax is imposed. His imme-

[5] Seligman, "Income Taxes and the Price Level," *Proceedings of the Academy of Political Science,* XI, No. 1 (May 1924), p. 11.

[6] *Ibid.,* p. 15.

[7] Seligman, *The Shifting and Incidence of Taxation,* pp. 358–359.

diate response, according to the generally accepted theory, is to look on the tax as an increased cost, and to try to raise his prices.[8] If he is successful, supply is reduced and the tax is shifted; if he cannot raise his prices, he bears the burden of the tax.

In contrast to Seligman, De Viti believed that the immediate effect of a general and proportional tax on all incomes should be studied from the side of demand rather than of supply. He contended that producers immediately after the tax will continue to supply in the market the same quantities that they supplied before the tax. The only difference will be that a portion of the produce —that portion representing the percentage of income to be taken in tax —will be sold for the benefit of the government. Thus no immediate effect of the tax on price can come from the side of supply. On the side of demand, however, De Viti predicted rapid changes. Since the tax is assumed to be a proportional tax on all incomes, it must reduce incomes by that proportion and thereby alter demand. Of course, as De Viti pointed out, a 10 per cent tax will not result in a 10 per cent decrease in the quantity of all goods demanded, but when each individual has an income only 90 per cent of its former size he will rearrange the relative shares of his income to be allocated to each expenditure. In this way an immediate effect on price will be produced by the tax through its effect on the demand curves for all commodities and services.[9] De Viti says that this effect was not observed by the classical economists, because they made the error of observing tax effects only from the view of the producer.

Another practice of the traditional economists which De Viti considered erroneous was that of divorcing the problems of public finance from those of private finance. They never traced the course of the tax money after it left the pockets of the consumers. "On the contrary, there is a general disposition to suppose that the tax represents a loss of wealth for the taxpayer and for society."[10] So De Viti, after he had observed that demand curves are altered by the levying of the tax, then turned to examine the use which the government makes of the money. He pointed out that obviously the government will not spend the money in exactly the same way in which the private incomes have been spent, for then there could be no reason for the tax levy.[11] The government will follow a different pattern of expenditure, with the result that the demand for some things will be greater than before and for others less.

There will be changes in prices corresponding to these changes in demand. When new government expenditures for a commodity exceed the decrease in private demand induced by the payment of the tax, price will rise; or conversely, when new government expenditures fall short of the decrease in individual demand for a commodity, price will fall. This brings about a shifting of the tax which will take place under either free competition or monopoly. "The producers of goods the demand for and price of which have in-

[8] Antonio de Viti de Marco, *First Principles of Public Finance*, trans. E. Marget (New York: Harcourt, Brace and Company, Inc., n.d.), p. 149.

[9] *Ibid.*, pp. 153–154.

[10] *Ibid.*, p. 149.

[11] *Ibid.*, pp. 153–154.

creased, shift the tax; the others feel its incidence."[12]

The second stage of tax shifting as examined by De Viti takes place on the side of supply with a "new distribution of productive services which is effected in order to adapt the supply to the new demand curves."[13] Supply is increased in those areas in which the tax has been shifted and demand has increased, while a decrease will be observed in those enterprises which have borne the burden of the tax through suffering a decrease in the demand for their products. The producers in these latter enterprises will, wherever possible, transfer to other more fortunate enterprises, while new investment will enter only the most profitable enterprises, until finally profits are equalized and a new equilibrium is reached. De Viti de Marco stated that

> in the case of free competition there will be a return to an equilibrium in which the phenomena of temporary shifting and of temporary incidence will be elided in the future, leaving intact, however, the gain that will have been made in the meantime by one group and the loss that will have been suffered by another.[14]

De Viti denied also the conclusion of Seligman that a tax on the profits of a monopoly cannot be shifted. In only one case, which De Viti considered an unusual one, a monopoly cannot shift the income tax. This exception occurs only when the collection of the tax and the expenditure of the receipts by the government make no change in the demand curve for the monopolist's product. When, however, the demand curve does change—and De Viti believed this more probable—the monopolist who formerly has achieved the most profitable output will find it advantageous to change his price and the volume of output. When the demand for his product increases, he increases his output, and in this way he shifts at least part of the tax.[15] Even if the demand for his product has decreased, he may relieve himself of part of the burden of the tax by reducing his output somewhat to match the reduced demand. This new level of output, accompanied by a further change in price, will now be the one which will give him the largest profit.[16] De Viti then concluded this discussion by stating that his "primary purpose has been to demonstrate the general truth that the introduction of a tax always gives rise to phenomena of shifting."[17]

3. Duncan Black

Black commended the use by De Viti de Marco of demand in the analysis of the incidence of taxation as a contribution towards a more perfect theory. The neglect of any examination of the effects of the tax on the supply of the factors of production, however, appears to Black to be a gap in De Viti's approach. Black attempted a synthesis of the two by combining "the *Colwyn Report's* treatment of the effects of the tax in producing variation in the supplies of the factors of production, with De Viti's treatment of the demand aspect . . ."[18]

[12] *Ibid.*, p. 154.
[13] *Ibid.*, p. 155.
[14] *Ibid.*, p. 155.

[15] *Ibid.*, p. 158.
[16] *Ibid.*, p. 159.
[17] *Ibid.*, p. 159.
[18] Duncan Black, *The Incidence of Income Taxes* (London: Macmillan & Company, Ltd., 1939), p. 42.

Black emphasized the importance of considering the effects on the economy produced by the expenditure of the tax revenue by the government. Although the error resulting from the neglect of expenditure is small in some instances, it was, in his opinion, wrong to ignore it. He gave as an example the case of a per unit tax levied on the manufacture of a particular commodity but with the revenue spent over a wide field. In such a case the effects on the particular industry brought about by a change in the cost of production may be conspicuous, whereas the effect on demand may be imperceptible. Nevertheless, he criticized the classical analysis for ignoring the effects of taxation that may occur outside the taxed industry.[19]

To Black it was no more reasonable to ignore the effect on demand of state expenditures than it would be to ignore the effect on supply of tax collection. He cited the case of taxes such as those on income or inheritance, which perhaps are collected from as wide a variety of sources as the field over which the receipts are spread. He granted that there may be no concentrated effects of expenditure which can be observed, but neither may there be any more concentrated effects on costs. In regard to the treatment of expenditures, Black adopted the "principle that if the imposition of a tax gives rise to an increase in governmental revenue, then the economic effects produced when this revenue is spent, ought to be taken into account in investigating the incidence of the tax." [20]

[19] *Ibid.*, p. 135.
[20] *Ibid.*, pp. 136–137.

4. *Why the Conclusions Differ*

A. The Treatment of Demand

One reason for the apparently contradictory conclusions reached regarding the incidence of the general income tax, then, clearly lies in the different treatments of demand and of the effect of government expenditures on demand. The immediate changes in demand brought about by the collection of the tax and the effects produced by government expenditures, however, are different problems which require separate treatment.

It is true that the traditional approach to incidence neglects the immediate response of demand to the levying of the tax. The *Report* of the Colwyn Committee, which professed general agreement with Seligman's theory of incidence,[21] does indicate the possibility of alterations in price by forces from the demand side. In regard to the effect of a general net income tax on a monopolist, the *Report* showed that no change will be brought about in his cost of production and that "it will not affect the price which the public are willing to pay for his goods, unless indeed, it makes them more careful purchasers." [22] The *Report* indicated further that a trader subject to income tax may lower his price, because "if he is a competitive trader . . . the consumer, who is also suffering from the increased tax on his income, will tend to be more careful to buy in the cheapest market." [23] These acknowledgments of possible price changes resulting from an altered demand,

[21] *Report of the Committee on National Debt and Taxation* (London: H. M. Stationery Office, 1927), p. 114.
[22] *Ibid.*, p. 112.
[23] *Ibid.*, p. 115.

however, were pursued no further, with the result that the conclusions of the Colwyn *Report* are those of traditional theory, recognizing shifting as taking place only through changes in supply.

The degree of sensitivity and the promptness with which demand can be expected to react to an increase in the income tax must depend in part on the method by which the tax is collected. For example, if the collection of the tax is delayed until the year following the one in which the income is earned and if taxpayers do not habitually accrue their taxes, a delayed reaction can be expected in demand. Consumers as a group may not curtail their expenditures until after the payment of the tax has forced an alteration in their habitual pattern of consumption. Since producers, on the other hand, are expected to keep accounts and to be more astute in handling their finances than the consumer, it is probable that the more immediate effects of an income tax collected from producers on the preceding year's income will be felt from the supply side, if any change in price is to occur. In the event, however, that the tax is collected currently at source, an increase in the tax rate will produce an immediate reduction in savings or total private demand or both, corresponding to the reduction in individual incomes.

Another element in the timing of the reaction of demand schedules to a tax is the position of the producer in the chain of production. Whenever the demand for final consumers' goods is reduced by the collection of an income tax, the effects may be transmitted back with growing force through each stage of production to the primary producer. The producers—especially the producers of durable goods—farthest removed from the consumer may be affected most by the decline in demand, since a reduced consumer demand will result in a more than proportional decrease in the demand for many producers' goods.

One justification for the frequent neglect of the demand aspect in analysis of the shifting of taxation may lie in the fact that, through the neglect of government spending too, some rough balance is achieved, since one omission to some extent offsets the other. The following statement from the Colwyn *Report* suggests that such an offsetting may have been assumed implicitly.[24]

> Finally, it may be noted that, according to the quantity theory of money, the general price level, given a certain constant volume of production, must depend on the quantity of purchasing power—money and deposits—and the velocity with which it circulates. An increase in the Income Tax could only enable traders in general to put up their prices, if at the same time it caused an expansion of currency or a more rapid circulation of money, enabling the prices to be paid. It is difficult to conceive how this could happen.

De Viti's accusation that the usual analyses of incidence regarded taxes as "a sort of hail that destroys part of the crop" [25] cannot be applied to the Colwyn *Report*. If the Committee had not recognized a balancing of the tax by government expenditure, they would have had to admit a reduction in purchasing power and, "according to the quantity theory of money," a reduction in the general price level. They must have recognized, without stating it, that the

[24] *Ibid.*, p. 119.

[25] De Viti de Marco, *op. cit.*, p. 52 n.

funds raised by taxation will be expended by the government instead of by individuals, and that this expenditure by the government must compensate roughly for the contraction of individual incomes resulting from the tax. If they had not recognized this, they would have found it necessary to consider the changes in total demand which would be the initial consequence of the collection of the tax. The approximate counterbalancing of reduced individual demand by increased government expenditure enabled them to put these two variables, consumer demand and governmental expenditures, aside under the assumption of *ceteris paribus*.

The seeming neglect of governmental expenditures, of which Black was so critical, can only be pointed to in the studies of "incidence." Government expenditures have had a place in the discussion of the indirect effects of taxation, the importance of which students of incidence have not minimized. The section on "The Incidence and Effects of Existing Taxes" in the Colwyn *Report* begins with a subsection dealing with the effects of expenditure by the government. This discussion, however, is not integrated with the examination of incidence as the following passage explains: [26]

> With a few insignificant exceptions, the existing taxes are not earmarked to any particular items of expenditure. The way in which the revenue is applied has, consequently, effects which may be related to the taxes generally, and not to any part of the system more than to another. For this reason it seems desirable to give some prior consideration to these effects of expenditure, and then to deal separately with the effects of the several taxes.

Among the indirect effects of a tax on business incomes, Seligman mentioned the possibility of effects on saving and investment, wages and prices. Whether such consequences arise depends

> first upon whether the taxes are used for fresh expenditure or to pay the interest on an old debt. If the taxes are used for new expenditure, the problem becomes one as to the relative productivity of private and public outlay. . . . Certain forms of government expenditure or investment may be far more productive than certain forms of private expenditure or investment.[27]

Another explanation, therefore, of the exclusion of expenditures from a consideration of incidence must lie in the different definitions of the word "incidence," which will be discussed further in a later section of this chapter. The point at present is that Seligman and the Colwyn Committee were well aware of the effects of government expenditure and that they took account of those effects outside their analyses of incidence.

In order to determine whether the inclusion of an analysis of the effects of state expenditures on demand renders the conclusions regarding incidence more useful, it is necessary to consider the purpose for which the tax is levied. If the tax is levied to finance certain specified public projects, then obviously any study which failed to take account of the expenditure of the revenue would give an incomplete account of the incidence of the tax. For example, if the proceeds from a tax on gasoline are earmarked for expenditure on highways, both

[26] *Report*, p. 97.

[27] Seligman, "Income Taxes and the Price Level," *op. cit.*, p. 20.

the supply of and demand for gasoline will be affected by the tax.[28]

Ordinarily, however, the revenue from a particular tax is not allocated to separate, definite ends. The proceeds of a tax levied on a specified type of enterprise may be spread by the government over a wide area. The tax revenues which enter the treasury are not allocated among expenditures on the basis of their origin. Therefore a tax may produce definite and observable changes in the costs of a particular enterprise, while its effect on demand is so weakly felt over the entire economy and so diluted with the effects of other taxes that any attempt to distinguish the effects of the particular tax on the demand for the products of a particular industry must fail.

It should be noted, too, that when a tax is levied to meet general expenditures, not even changes produced in the economy as a whole can be attributed to that tax alone. The importance of governmental expenditures should not be minimized, but since changes in expenditure usually precede changes in revenue programs, it may be assumed that the expenditures will be made regardless of the method by which the government raises its funds.[29] Therefore the effects of expenditure which De Viti de Marco would have attributed to a particular tax may be expected to occur whatever type of tax is employed or even if the funds are raised by loans.

Even when a tax is levied with non-fiscal objectives, the expenditure of the funds need not enter into a determination of the incidence of that tax, when "incidence" is narrowly defined. The selection of the tax by which government revenues are to be raised, however, should be made only in the light of careful consideration of the objectives to be achieved. If public expenditures are planned in a depression to stimulate consumer purchasing by putting funds into the hands of the members of the lowest income groups or of the unemployed through relief or public work programs, then the tax program planned to finance these expenditures should be planned with these objectives in mind in order not to counteract them. If, however, the additional revenue is raised by means of an increase in the rates of a progressive income tax, it cannot be said that the increased expenditure of the poor is a result of the tax, because the same results might have occurred had the expenditures been met by borrowing. In wartime expenditures for armament are planned with little regard for how the funds are to be raised. The limit to government expenditures is the power of the industrial system to produce war equipment in addition to essential civilian goods. Therefore when a tax is levied during the war, regardless of any non-fiscal aims which may be attached to it, the increase in consumer purchasing power produced by government expenditure cannot be considered a result of the tax, because the expenditure would be made whether sales taxes, income taxes or loans were em-

[28] Black, *op. cit.*, p. 136; M. Slade Kendrick, "Public Expenditure: A Neglected Consideration in Tax Incidence Theory," *American Economic Review*, XX (June 1930), 227–230.

[29] The revenues and expenditures of governments frequently are treated as more or less independent variables. See, for example, Alvin H. Hansen, *Fiscal Policy and Business Cycles* (New York: W. W. Norton & Company, Inc., 1941); John Maynard Keynes, *The General Theory of Employment Interest and Money* (New York: Harcourt, Brace and Company, Inc., 1936).

ployed.) The preceding paragraphs must not be interpreted as suggesting that the problem of incidence should not be concerned with particular taxes. Unless, however, the effects of the expenditure of government revenues can be related to specific taxes, such effects of expenditure must be excluded from an incidence study.

Thus there seems to be little justification for the recognition of government expenditure in a study of the incidence of a general income tax. There is more to be said, however, for including in an incidence study the immediate effect on demand of the payment of a tax. In war finance, for example, although the expenditures will be made by the government under any circumstances, the effect on total consumer demand will vary with the tax policy. A tax removing from the hands of consumers funds which otherwise would have been spent will produce effects quite different from a tax absorbing funds which, in the absence of the tax, would have been saved. The Keynes plan for financing the war has as its chief aim the prevention of inflation.[30] The choice of a progressive income tax as one of the chief implements of the plan could not have been arrived at, if the effect of the payment of the tax on consumer demand had not been taken into account in determining the effects on price of the tax. In a depression, too, as was indicated above, the incidence of a tax, in most cases, can be examined satisfactorily without any inclusion of the effects of governmental expenditures, but the effects of taxation and, therefore, a proper nondeflationary tax policy cannot be arrived at without recognizing that consumer demand does respond differently to the collection of different taxes.

The omission of the effects which the income tax has on demand does not invalidate the theory as presented by Seligman, because one of its assumptions is that the economy is functioning normally and that the factors of production are fully employed. Seligman states that "there is only one possible weakness" in his conclusion that a general income tax cannot be shifted.[31] This weakness, he pointed out, may be revealed during periods of rapidly changing prices. In a boom when demand rises more rapidly than supply with a resulting depletion of goods, prices will tend to rise. Any tax imposed during such a period may be followed by increased prices, but Seligman regarded the tax merely as an excuse for a price rise that probably would have occurred in the absence of the tax. In the succeeding period of contraction the effort of producers to dispose of the accumulated stocks of goods will force prices down regardless of tax burdens.

It was not to such abnormal times that Seligman intended his theory applied. He wrote: [32]

> Under normal conditions, however, when there is neither a business boom nor a business depression, when there is neither a sellers' market nor a buyers' market, but just an ordinary, normal, average market, the producer will not even have an excuse for adding an income tax to the price.

Under such "normal" circumstances the effect of government expenditures on total demand is not expected

[30] J. M. Keynes, *How to Pay for the War* (New York: Harcourt, Brace and Company, Inc., 1940), pp. 34–44.

[31] Seligman, "Income Taxes and the Price Level," *op. cit.*, p. 17.

[32] *Ibid.*, p. 18.

to be more than a compensation for the decrease brought about by the collection of the tax. Of course total demand will not be distributed in the same way as before the tax, and the effects on particular enterprises will vary, but the economy as a whole will be changed little, except to the extent that government expenditures may differ in their productivity from the individual ones which they replace.

The two cases mentioned above, of war and depression, are not normal in this sense. In a depression it may be the aim of a government to spend more than the amount by which it has depleted spending power. While in wartime it is desirable to deplete purchasing power as much as possible in order to try to overtake government expenditures which are having the effect of increasing total consumer demand when there is an inadequate supply of goods to meet that demand. An incidence theory, if it is to be applicable to less "normal" times, cannot afford to omit from its reckoning the reduction of total demand by the collection of the tax, because there probably will not be even a rough compensation through public expenditures.

B. *The Definition of Incidence*

A second cause of the opposing conclusions reached regarding the incidence of the income tax lies in the definition of "incidence" itself. In the extensive writings of Seligman on the subject, it is difficult to find any limiting definition of incidence. The following statements perhaps best explain his terminology.

> With the wider questions of the general effects of taxation the student of incidence does not primarily busy himself. What he has particularly to investigate is the question: On whom does the tax ultimately fall? . . . The shifting is the process; the incidence is the result; the changes in the distribution of wealth are the effect.[33]
>
> The problem of the shifting of taxation is primarily a question of prices. To solve it is to discover whether, and to what extent, the imposition of a tax effects changes in the revenues and the expenses of individuals; in other words, to ascertain which of the two parties to every economic transaction—the buyer and the seller—bears the burden of the tax . . . the essence of the inquiry is: Are prices raised, and if so, to what extent are they raised? Whether we deal with the prices of consumable commodities, of capital, or of labor, that is always the nature of the problem.[34]

Seligman described income taxes and excess profits taxes as taxes "where the influence on prices is indirect rather than direct."[35] The indirect effects on prices may be felt through a reduction of investment, enterprise or demand. These effects, however, were excluded from his discussion of incidence.

The Colwyn Committee, while claiming in its report to follow the usage of economists, defined incidence much more narrowly as concerning only "the question on whom the more immediate burden of the tax as a tax rests."[36] The narrowness of the Committee's definition is brought out in their illustration of the case of an employee who, when subject to a tax, "succeeds, on that account, in obtaining an increase of wages against the tax-burden." Their conclusion is that the incidence is on

[33] Seligman, *The Shifting and Incidence of Taxation,* pp. 14–15.

[34] *Ibid.,* p. 217.

[35] Seligman, "Taxation and Prices," *Proceedings of the Academy of Political Science,* XI, No. 2 (January 1925), p. 250.

[36] *Report,* p. 106.

the employee "although the immediate burden of the tax is the cause or occasion of his obtaining a benefit which can be set on the other side against it."[37] Seligman, however, stated: "In the case of ordinary unskilled labor, if wages are near the minimum of subsistence, a special tax on wages . . . will be apt to be shifted in first instance to the employer in the shape of higher wages . . ."[38] Thus in identical situations the Colwyn Committee would have denied shifting while Seligman would have described the tax as shifted.[39]

De Viti de Marco's definition of incidence does not appear to differ from Seligman's when De Viti said that shifting "occurs when the tax which the law imposes on a taxpayer, who is called the taxpayer *de jure,* is unloaded by the latter, in whole or in part, upon other citizens, who are called the taxpayers *de facto.*"[40] The taxpayer's ability to shift the tax, however, must await the determination of the effect of the imposition of the tax on consumer demand and government demand for his product. If the result is an increased demand for his product he is able to shift the tax and its incidence will fall elsewhere, but if he is unable to shift the tax, because of a decreased demand, then the incidence is on the producer.

When the individuals, as producers or consumers, are compelled by the diminution in income resulting from the incidence of the tax to curtail their consumption and thereby to affect the incomes of those producers who cater to their demands, the tax is said by De Viti to be diffused. No sharp distinction appears between diffusion and the process by which reduced demand transmits to the producer the knowledge that he cannot shift the tax. When De Viti defined diffusion he remarked: "Diffusion, unlike shifting, is a phenomenon which is necessarily involved in every tax, since every tax must somehow bring about a contraction in the consumption of private goods."[41] Later, however, he appears to have discarded this distinction for he concluded, as noted above, that "the introduction of a tax always gives rise to phenomena of shifting."[42]

One difference between De Viti's approach and Seligman's is that to De Viti the producer is passive, waiting to learn from the reactions of the consumers whether he is to bear the burden of the tax or to shift it. Whereas Seligman made the consumer a passive factor, waiting to see whether competition or the best interests of the monopolist, as the case may be, will allow the producer to raise his price to protect his former profits.

[37] *Ibid.*, p. 107.

[38] Seligman, "Income Taxes and the Price Level," *op. cit.*, p. 9.

[39] Black criticized the definition of incidence given in the Colwyn *Report* as follows:

1. The definition of incidence is not that used by economists as the Committee claimed. The Committee's definition implies that incidence is exclusively a short period phenomenon, which Black pointed out is not the definition of traditional economics.

2. Their meaning of incidence is obscure and is not clarified by their illustrations. The Committee defined incidence as concerning "the more immediate burden of the tax," then introduced "a distinction other than that of time, a distinction which appears to depend on whether the person concerned is, or is not, liable to payment of the tax." (Black, *op. cit.*, pp. 31–33.)

[40] De Viti de Marco, *op cit.*, p. 141.

[41] *Ibid.*, pp. 142–143.

[42] *Ibid.*, p. 159.

Black used the term, incidence, in a much broader sense.[43]

> The incidence of a tax is the group of economic effects which it brings into existence. These economic effects will mainly consist of alterations in commodity prices and in the flows of commodities per unit of time; in alterations of factorial prices and in the flows of the factors of production into the production process: the economic effects (and therefore the incidence) will consist also of changes in revenue and cost schedules of firms, and in changes in the distribution of wealth brought about by the tax. The theory of incidence is concerned with all of these topics.

Black therefore arrived at conclusions different from Seligman's, both by following De Viti in discussing the influence of the tax on demand and by discussing, under the head of incidence, topics which Seligman excluded by definition.

C. *Other Differences*

Another point of difference between Seligman and Black revolves around the transferring of capital. When a general income tax is levied, Seligman said: [44]

> If everyone is taxable upon his income, from whatever source derived, there is no taxless field to which he can repair. If he pays the tax in the first instance, he cannot improve his position by transferring his capital and his energies to some other business or occupation; for he would meet in the new enterprise precisely the same conditions, so far as the tax is concerned as in the old one.

Black, because of his emphasis on changes in demand and the expenditures by the government, was unwilling to grant the assumption that there will be no alteration of the relative profitableness of different businesses.[45] In addition Black was critical of the view which does not recognize that there are other considerations than monetary ones to determine the distribution of capital and entrepreneurial ability among their various uses. A general income tax alters only the monetary reward from each occupation and leaves the other advantages and disadvantages unchanged. Although Black concluded that the nature of the transfers cannot be determined, he regarded it as inaccurate to say that no incentive is set up by the tax to change the distribution of capital among businesses.[46]

An entrepreneur, however, who had entered a business less attractive to him than some other enterprise, but one which paid a higher monetary reward, must have placed a relatively high subjective valuation on that income. Although a proportional income tax would alter the absolute difference between money incomes, it would not change the relative difference. In most cases it appears likely that, if the income in the otherwise more attractive field seemed insufficient before the tax, the decreased income would not cause the entrepreneur to leave the business in which he is established and from which he still obtains more money. Although it is possible to think of situations, especially when the rate of the tax is high, in which Black's criticism is valid, they probably would occur so infrequently as to be of little importance in determining the incidence of the income tax.

Another argument of traditional theory which has not escaped criti-

[43] Black, *op. cit.*, pp. 123–124.

[44] Seligman, "Income Taxes and the Price Level," *op. cit.*, p. 11.

[45] Black, *op. cit.*, p. 11.

[46] *Ibid.*, p. 10.

cism is that presented by both Seligman and the Colwyn *Report* that, since price is determined at the marginal cost of production, a net income tax cannot affect that portion of the product which is responsible for price determination and therefore cannot affect price.[47] D. H. Robertson has criticized, not their conclusions regarding the effects of income taxes, but their logic.[48] He accused Seligman of an uncertainty as to what constitutes costs of production.[49]

> It makes surely all the difference in the world whether we are or are not to reckon among the costs of the marginal producer, which *ex hypothesi* determine price, all such profits as may properly be regarded as wages of management or remuneration for risk; yet Professor Seligman leaves us uncertain.

Robertson also objects to the prevailing notion regarding the type of firm whose cost of production equals price.[50]

> I do not think any warrant can be found in Marshall's pages either for the view that the costs of production which are relevant to the determination of normal value are those of the most inefficient or unfortunate producers, or for the view that they do not comprise a substantial element of profit.

Furthermore all actual income taxes are necessarily crude in that the statutory base cannot be expected to be identical with pure economic profit for every firm in every year. Discrepancies between the statutory and theoretical profit and also discrimination among firms may arise in several ways. Among the possible sources are inadequacies in the determination of capital values against which depreciation and depletion are calculated, different methods of valuing inventory, and the failure of tax laws to allow for irregularity of income among accounting periods. One of the assumptions necessary to the argument that a general income tax is not shifted is that the tax does not affect the cost of producing the marginal unit. A second assumption is that the tax in no way discriminates among producers. These assumptions will be invalidated if a general income tax reduces normal profit which should be included in the costs of production or if the tax because of some imperfection strikes the normal profits of firms unequally.

Conflicts also may arise in the study of incidence through a confusion of time periods. Mr. W. H. Coates, in his study which will be examined in more detail in the next chapter, concluded that the business men were applying the long run conclusions of the economists to a short period.[51] The alterations of demand functions that follow the levying of a tax in De Viti's analysis are clearly short-run phenomena; then when he extended his discussion into the second stage of shifting, where supply adapts itself to the altered demand, he was dealing with a long run process.[52] Accuracy and clarity demand that a discussion of incidence shall be

[47] *Report,* p. 114; Seligman, "Income Taxes and the Price Level," *op. cit.,* p. 15.

[48] D. H. Robertson, "The Colwyn Committee, the Income Tax and the Price Level," *Economic Journal,* XXXVII (December 1927), 581.

[49] *Ibid.,* p. 567.

[50] *Ibid.,* pp. 568–569.

[51] W. H. Coates, "Memorandum on the Incidence of the Income Tax," *Appendices to the Report of the Committee on National Debt and Taxation* (London: H. M. Stationery Office, 1927), p. 70.

[52] De Viti, *op. cit.,* p. 155.

related definitely to a specific period of time.

In an appraisal of current theory regarding the incidence of the general income tax, Professor Eugene E. Oakes has concluded that practical decisions of tax policy are "being made very largely on noneconomic grounds."[53] In Professor Oakes' opinion, the recent trends in general economic theory have brought a need for a revision of the theory of incidence, especially in line with the new developments

> dealing with money flows, expectations, and the so-called 'dynamic' economics. . . . Yet it is quite obvious that an integration of this sort will produce a far more complex tool of analysis, a much more qualified basis for prediction, and probably far more limited grounds for the drawing of sharp distinctions between the economic results of alternate forms of general taxation.[54]

Professor Oakes did not offer much encouragement that the theory of incidence will make an early advance beyond its present state, under which "a really careful appraisal of the economic merits of . . . tax policy is not possible. . . ."[55]

[53] Eugene E. Oakes, "The Incidence of the General Income Tax," *American Economic Review*, XXXII, No. 1, Part 2, Supplement (March 1942), 82.

[54] *Ibid.*, p. 81.

[55] *Ibid.*, p. 82.

5. *Summary*

The purpose of this chapter has not been to arrive at any conclusive statement regarding the incidence of the general income tax, nor to choose the most useful from among the theories mentioned. Rather the purpose has been to indicate the present status of the theory of the incidence of the general income tax, as a background for an examination of the incidence of the excess profits tax. It must be clear that in order to avoid confusion a study of the incidence of a tax based on income should establish clearly at the outset its position on each of the following questions:

1. Will the effect on demand produced by the collection of the tax be recognized in the analysis?
2. Will the effect on demand produced by the government's expenditures of the tax receipts be recognized?
3. How is incidence to be defined?
4. What is to be included in costs of production?
5. Through what time period is the incidence examined?

Several studies which have dealt with partial taxes or which have examined only corporate taxes will be reviewed next to see whether there may be in them some results more directly applicable to a theory of excess profits taxation.

25

JOHN F. DUE

The Incidence of Sales Taxes

IT IS frequently concluded that all sales taxes are uniformly shifted to consumers and that both the process and the result are sure and simple. A precise analysis of what takes place after a sales tax is imposed requires attention to many factors, including the following:

1. conditions in both the individual firm and the industry;
2. whether production is under conditions of increasing, decreasing, or constant cost;
3. marginal and average costs and revenues of the firm;
4. the degree of monopoly—pure monopoly, pure competition, or monopolistic competition;
5. adjustments of volume and price in the short run and in the long run;
6. elasticity of demand.

It is impossible to present here the extremely complicated analysis necessary to trace properly the incidence of any one of the several varieties of sales taxes. An excellent analysis of this kind by John F. Due has been published. Some idea of its nature can be had from the conclusions to the chapter on retail sales taxes and from a summary of the conclusions to the chapter on monopolistic competition: *

Conclusion [*on retail sales taxes*]

The chief feature of incidence of general retail sales taxes can be summarized briefly. The initial reaction of retail firms, operating inevitably in conditions of monopolistic competition, although with widely varying strength of the monopoly elements, will be to raise prices at least by the full amount of the tax, either by adding the tax to the regular price as a separate charge, or by readjusting markup to include this additional cost item. In addition, since retail firms operate normally in decreasing cost conditions, a further increase, to compensate for the higher cost per unit of the reduced volume

* Reprinted by permission from *The Theory of Incidence of Sales Taxation* (New York: King's Crown Press, Columbia University, 1942), pp. 162–165; 81–82. The reader will probably find himself unprepared to follow all of this selection. The subject is difficult enough even after reading the more elaborate analysis by Professor Due that precedes these summaries. The reading should serve, however, to give the reader some conception of what the field involves.

of business, will ordinarily occur, especially where firms earn no excess profits and thus can escape loss only by such an increase. The short run increase will be greater than that in the long run, since plant can be adjusted in the latter, but not in the former; with average cost pricing followed in retailing, fixed costs are included in cost for price-making purposes. This immediate and full increase is possible only because of the importance of oligopoly in retailing. Because of the nearly universal markup practices, each firm ordinarily realizes that other firms will treat this tax as an addition to cost and raise prices fully, provided the firm in question does also; as each acts in this manner, the price rise brings a relatively slight reduction in sales. If strict marginal pricing practices were followed, and each firm ignored the action of his competitors, the price rise would be small. With excess profits there would be no further change; without excess exodus would occur. In this case, price would rise sufficiently to shift the full tax to the consumer; there would be no further increase necessitated by the decreasing cost nature of the individual firms. Laws requiring separate charging are of considerable significance because they serve to strengthen the forces leading to uniform action which is essential to immediate full increase.

However, the initial tendency to add the entire tax to the retail prices is subject to modifications. The differences in conditions of cost and competition under which various commodities handled are manufactured will cause different types of change in retail purchase prices as volume falls, and cause readjustments in the prices which retailers charge. Retailing costs will not be the same in all fields, and will differ even for lines in the same store, especially because some lines customarily contribute nothing to overhead. Further, demand elasticity will vary widely as between lines. In some cases the demand will appear so elastic that average revenue will rise more slowly (at reduced levels of output) than average cost. The line may be dropped; however, ordinarily a reduced contribution to overhead will be accepted, and further increase made in other lines. This can be done profitably if all firms act in similar fashion. Among the conditions which will produce such great elasticity are the existence of customary prices and class lines, which can be varied only with great loss in volume, an exceedingly great elasticity of demand for the entire product on the part of the consumers, as when close substitutes are untaxed, and a high degree of price competition. There is no certainty that all firms will raise; there is always likelihood that some firms will attempt to avoid losses by gaining greater volume at the old price level; if this occurs in a few lines, the multiple line stores will try to pass the tax on these lines off onto other goods. When, however, this occurs in many lines, price increases will be accompanied by severe losses in volume of sales. Accordingly, exodus of firms must occur before the tax is shifted to consumers, unless excess profits are sufficiently great. In one case exodus is inevitable; namely, when the original price was the optimum monopoly price because of great strength of oligopoly elements.

Where retail prices are set by manufacturers, or by law, there is even more certainty that the entire

tax plus, ordinarily, some additional amount for higher cost of operation per unit, will be shifted immediately. Legal regulation of prices provides ordinarily that prices must be sufficiently high to cover cost. They will be adjusted accordingly to include the tax and higher operating costs. The manufacturer usually will be forced to readjust margins allowed; if the bargaining power of the retailers is weak, only the tax, or even less, will be added.

Wherever the retail price is beyond the control of the retailer and the latter is not able to force change, the tax will often be shifted by quality reduction. Delivery and credit will be eliminated; variety of goods reduced, etc. Again, this is profitable only if all firms act in unison, or those lowering quality will lose volume so heavily as to suffer loss. The uniform action is, however, likely to occur, and if sufficiently great may prevent any exodus. Where both price and quality can be varied, some change in the latter is almost certain, but the nature of the change depends on the peculiar circumstances of each case.

All that has been said above applies equally well to special or general retail sales taxes. It must be emphasized that in the case of the former, just as in the case of the component parts of the latter, part or all of the burden may pass onto consumers of other commodities than the one taxed. This will be the case if price increases will cause less loss in sales in the untaxed lines and if all firms act more or less in unison, or if exodus of firms occurs. Ordinarily, however, the tax will rest on the consumers of the commodity on which it is imposed. The source of the essential differences between incidence of special and general levies is the secondary reaction which occurs when the tax is of general nature. The reduction in sales caused by the increased prices will lessen the total volume of output and employment, except as checked by the rise in the propensity to consume as people use part of the income formerly saved to meet the higher prices. This decreased investment, employment, and income is likely to cause some fall in interest rates. In terms of the orthodox theory of distribution, the fall in interest will continue until all workers have been reemployed and the old level of output restored. The entire burden of the tax, apart from modifications introduced by changes in the volume of savings, would be shifted to capital owners. Even when the orthodox theory is questioned, it will be realized that some interest rate fall is likely, and, with proper governmental action, may be of considerable amount. Accordingly, production will expand, and the volume of retail business will increase. Not only can retail firms operate on lower margins, but the volume of physical production becomes greater. Prices at retail will fall because of the reduced production and distribution cost, and the burden will in part pass from consumers to interest-receivers.

Thus, in general, while the initial reaction of retailers will be to add the entire, or in most cases, more than the entire tax to prices charged, there will be considerable variation as between price changes on different commodities. Furthermore interest rate declines coming about to restore, in part at least, the old volume of investment and employment, may serve to restore prices toward the old levels and pass a part of the burden onto interest receivers.

* * * *

Thus, in summary: *

1. With monopolistic competition, in the special case of absence of excess profits, incidence will be the same as with pure competition apart from the possible operation of certain modifying factors indicated in the analysis above.

2. The importance of monopoly profits provides possibility of absorption of greater amounts of the tax. Even without any feeling of mutual interest, however, price increase will be greater, cet. par., than with pure monopoly.

3. Despite excess profits, price increase will normally approach that of pure competition. The importance of oligopoly elements, with common cost accounting and average-pricing methods, allows the tax, which appears as a common and uniform increase in cost, to facilitate a price increase by the full amount of the levy. The increase is thus greater than with pure monopoly, the price level being adjusted nearer to the full monopoly level. This is, of course, not the necessary result; few fields are entirely free of price cutters, the activities of which interfere with the price increases. The increase will be checked also in the fields in which demand for the products of the firms is very elastic for price levels higher than the old for reasons other than the presence of price cutters.

4. In many cases, not only will price be raised by the full tax, but by an additional amount to compensate the firms for reduced volumes of output. Strong oligopoly and strict average cost pricing will bring this result, and allow retention of the original number of firms even when no excess profits existed. Not only is the consumer forced to bear the entire tax, but likewise the secondary burden normally resting upon owners of the factors forced to leave the field or suffer reduced returns.

5. In the short run period, the difference is particularly striking in contrast to incidence under pure competition. The price increase, in full or in part, comes at once without exodus of firms; the latter, when it occurs, serves for the most part simply to restore profitable operation. With strict average cost pricing, the immediate price increase will be greater than that after readjustment of capacity has taken place.

* Of the chapter on "Monopolistic Competition and the Incidence of Special Sales Taxes."

HERBERT D. SIMPSON

The Incidence of Pay-roll Taxes

THE incidence of pay-roll taxes is another complicated and controversial field. Professor Herbert D. Simpson's conclusions on the subject are summarized as follows: *

We may now assemble the results of our inquiry.

I. *The Employee's Tax*

The employee's tax is a net income tax, with payment at the source. The alternate inducements for any employee in trade or industry to shift voluntarily to agricultural or domestic employment in order to secure a slightly lower pay-roll tax are so far-fetched that it seems inconceivable that they can have any material effect on the supply of labor at any point.[1] In this situation the employee has no opportunity to shift his tax to the employer in the form of higher wages; and no opportunity to shift it through the employer to the consumer in the form of higher prices. Consequently, the employee will bear the burden of his own tax, just as he will bear the burden of any other income tax that may be levied upon his income.

II. *The Employer's Tax*

In connection with the employer's tax we have pointed out the fallacy of the popular belief that all taxes are ultimately borne by the consumer. We have called attention likewise to the fallacy of the theory advanced by many economic writers at the present time that because a tax is *levied on wages or with respect to wages*, it must necessarily be borne by labor. We have pointed out that the way in which the tax is levied—whether on wages *as income* to the recipient or on wages *as expense* to the employer, will make a material difference in the impact of the tax.

In the case of the pay-roll tax, the employer's tax becomes an additional cost of production. It rests on mar-

[1] It should be noted that in the discussion of flexibility of labor supply we were referring to shifts *within* the general field of trade and industry, brought about by decreased employment or pressure for reduced wages in high labor-cost industries. In such cases the employee's tax itself, under present proposals, is uniform. Here we are referring to the possibility that employees may endeavor to reduce their own taxes by transferring to areas where the pay-roll taxes are lower. Under present proposals, these areas are limited virtually to agricultural and domestic employment, which would involve a much more violent change than merely shifting from one plant or industry to another.

* Reprinted by permission from *Compulsory Health Insurance in the United States*, Northwestern University Studies in the Sciences, No. 5 (Evanston: Northwestern University, 1943), pp. 48–51.

ginal producers and marginal portions of production as well as on producers more favorably situated. In the effort of marginal or high-cost producers to curtail production at a loss or to secure the higher prices that will enable them to continue production, all the pressures are developed that normally follow any increase in the costs of production.

These pressures bear in three possible directions, any one of which may relieve the strain: pressure for higher prices to consumers; pressure for lower wages and other costs; and failing these, pressure upon profits in the form of lower profits for more or less all producers.

The relative impact in any of these directions depends upon the relative resistance encountered. We have pointed out that none of these factors is so completely helpless—in economic terms, so completely "inelastic"—that it can be compelled to accept the whole burden. Some consumers will yield readily to higher prices; some producers, favorably situated, will succumb readily to absorption of the tax; some groups of labor will find an increased obstacle to further increases of wages. The result will be that the tax will register some impact on all three factors involved, varying according to the resistance encountered.

Even if the tax were uniform over all industries, the varying "elasticities" of the groups concerned would make shifting possible. But the most important condition of shifting here is the fact that the tax *is not* uniform. Being a tax on wages, its impact on costs will vary with the proportions which labor costs represent in total costs of various industries. The result will be a high tax on some industries and a low tax on others; and this is a condition which always makes shifting possible.

Equilibrium will be re-established when the various readjustments in prices, volume of production, and volume of employment have been made. These readjustments will represent more or less the final results of the tax, so far as we can speak of "final" at any one time.

Labor will, therefore, come in contact with the pay-roll tax at three points:

1. In the payment of its own pay-roll tax.
2. In bearing a portion of the employer's tax in the form of higher prices for the goods it purchases.
3. In bearing a further portion of the employer's tax in the form of some increased obstacles to future wage increases.

Finally we have pointed out certain concrete effects of the pay-roll tax in broader areas:

1. It will stimulate the introduction of labor-saving machinery.
2. It will put a premium upon instability of employment policies and a penalty upon those employers who have followed a policy of carrying labor personnel over periods of temporary irregularity and unemployment. In both of these respects, the pay-roll tax will be the opposite of the various types of "incentive" taxation that have been proposed for the purpose of increasing employment.
3. It will put a premium upon imports in certain fields at the expense of domestic production.

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CHAPTER 4

NET INCOME TAXES

THE net income tax is probably the most rational means of raising revenue in a modern capitalistic state. It is axiomatic that practically all taxes come out of somebody's income. The presumption is in favor of those which come out of income directly and in some relation to the size of the income.

Unfortunately the application of this rational theory is much more difficult than its logical defense. To begin with, the concept of income itself is by no means a closed question. Receipts growing out of exchange are clearly included; but what about receipts from the self-service part of the economy, such as the services of one's home and garden, and of the housewife? What about the services of cooperative undertakings?

Like the property tax, the levy on income is not simple to administer or to collect. Modern innovations, such as collection at the source and current payment, have solved some problems in this area, but many others remain.

In the application of the income tax to corporations we encounter capital gains, stock dividends, undistributed profits, and excess profits. Whether the tax can be applied rationally to corporations as such, apart from their stockholders, is itself a moot question.

There are income taxes and income taxes. Some have a broad and some a narrow base. This involves the size and purpose of the exemptions allowed the taxpayer and his dependents.

Other income tax problems include loopholes and ways to stop them; multiple taxation and means of apportioning and allocating income; state and local use of the tax; and devices of coordination with the federal tax.

This chapter is devoted to these primary aspects of the income-tax problem.

27

HENRY SIMONS

The Definition of Net Income

DIFFICULTIES in net income taxation begin with the definition of income. Some of these difficulties are considered below by Professor Henry Simons: *

Although personal income is not amenable to precise definition, it has, by comparison with the concept of social income, a much smaller degree of ambiguity. Its measurement implies estimating merely the *relative* results of individual economic activity during a period of time. Moreover, there arises no question of distinction between production and predation. Social income implies valuation of a total product of goods and services; while personal income is a purely acquisitive concept having to do with the possession and exercise of rights.

Personal income connotes, broadly, the exercise of control over the use of society's scarce resources. It has to do not with sensations, services, or goods but rather with rights which command prices (or to which prices may be imputed). Its calculation implies estimate (*a*) of the amount by which the value of a person's store of property rights would have increased, as between the beginning and end of the period, if he had consumed (destroyed) nothing, or (*b*) of the value of rights which he might have exercised in consumption without altering the value of his store of rights. In other words, it implies estimate of consumption and accumulation. Consumption as a quantity denotes the value of rights exercised in a certain way (in destruction of economic goods); accumulation denotes the change in ownership of valuable rights as between the beginning and end of a period.

The relation of the income concept to the specified time interval is fundamental—and neglect of this crucial relation has been responsible for much confusion in the relevant literature. The measurement of income implies allocation of consumption and accumulation to specified periods. In a sense, it implies the possibility of measuring the results of individual participation in economic relations *for an assigned interval* and without regard for anything which happened before the beginning of that (before the end of the previous) interval or for what may happen in subsequent periods. All data for the measurement would be found, ideally, within the period analyzed.

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value

* Reprinted by permission from *Personal Income Taxation* (Chicago: University of Chicago Press, 1938), pp. 49–55.

of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning. The *sine qua non* of income is *gain*, as our courts have recognized in their more lucid moments—and gain *to* someone during a specified time interval. Moreover, this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.

This position, if tenable, must suggest the folly of describing income as a flow and, more emphatically, of regarding it as a quantity of goods, services, receipts, fruits, etc. As Schäffle has said so pointedly, "Das Einkommen hat nur buchhalterische Existenz." [1] It is indeed merely an arithmetic answer and exists only as the end result of appropriate calculations. To conceive of income in terms of things is to invite all the confusion of the elementary student in accounting who insists upon identifying "surplus" and "cash." [2] If one views society as a kind of giant partnership, one may conceive of a person's income as the sum of his withdrawals (consumption) and the change in the value of his equity or interest in the enterprise. The essential connotation of income, to repeat, is *gain*—gain *to* someone during a specified period and measured according to objective market standards. Let us now note some of the more obvious limitations and ambiguities of this conception of income.

In the first place, it raises the unanswerable question as to where or how a line may be drawn between what is and what is not economic activity. If a man raises vegetables in his garden, it seems clearly appropriate to include the value of the product in measuring his income. If he raises flowers and shrubs, the case is less clear. If he shaves himself, it is difficult to argue that the value of the shaves must also be accounted for. Most economists recognize housewives' services as an important item of income. So they are, perhaps; but what becomes of this view as one proceeds to extreme cases? Do families have larger incomes because parents give competent instruction to children instead of paying for institutional training? Does a doctor or an apothecary have relatively large income in years when his family requires and receives an extraordinary amount of his own professional services? Kleinwächter suggests [3] that the poorest families might be shown to have substantial incomes if one went far in accounting for instruction, nursing, cooking, maid service, and other things which the upper classes obtain by purchase.

[1] Quoted by Schmoller (*op. cit.*, p. 54) from Schäffle, "Mensch und Gut in der Volkswirtschaft," *Deutsche Vierteljahrschrift* (1861).

[2] This point, with all its triteness, can hardly be overemphasized, for it implies a decisive criticism of most of the extant definitions of income. Professor Hewett, e.g., asserts and implies consistently that income is merely a collection of goods and services which may, so to speak, be thrown off into a separate pile and then measured in terms of money. He and others too, no doubt, know better; but, when one undertakes the task of definition, one may expect to be held accountable for what one literally says.

[3] *Op. cit.*, Introduction. We have drawn heavily, in this and other passages, on Kleinwächter's conundrums.

A little reflection along these lines suggests that leisure is itself a major item of consumption; that income per hour of leisure, beyond a certain minimum, might well be imputed to persons according to what they might earn per hour if otherwise engaged. Of course, it is one thing to note that such procedure is appropriate in principle and quite another to propose that it be applied. Such considerations do suggest, however, that the neglect of "earned income in kind" may be substantially offset, for comparative purposes (for measurement of relative incomes), if leisure income is also neglected. For income taxation it is important that these elements of income vary with considerable regularity, from one income class to the next, along the income scale.

A similar difficulty arises with reference to receipts in the form of compensation in kind. Let us consider here another of Kleinwächter's conundrums. We are asked to measure the relative incomes of an ordinary officer serving with his troops and a *Flügeladjutant* to the sovereign. Both receive the same nominal pay; but the latter receives quarters in the palace, food at the royal table, servants, and horses for sport. He accompanies the prince to theater and opera, and, in general, lives royally at no expense to himself and is able to save generously from his salary. But suppose, as one possible complication, that the *Flügeladjutant* detests opera and hunting.

The problem is clearly hopeless. To neglect all compensation in kind is obviously inappropriate. On the other hand, to include the perquisites as a major addition to the salary implies that all income should be measured with regard for the relative pleasurableness of different activities—which would be the negation of measurement. There is hardly more reason for imputing additional income to the *Flügeladjutant* on account of his luxurious wardrobe than for bringing into account the prestige and social distinction of a (German) university professor. Fortunately, however, such difficulties in satisfactory measurement of relative incomes do not bulk large in modern times; and, again, these elements of unmeasurable psychic income may be presumed to vary in a somewhat continuous manner along the income scale.

If difficulties arise in determining what positive items shall be included in calculations of income (in measuring consumption), they are hardly less serious than those involved in determining and defining appropriate deductions. At the outset there appears the necessity of distinguishing between consumption and expense; and here one finds inescapable the unwelcome criterion of intention. A thoroughly precise and objective distinction is inconceivable. Given items will represent business expense in one instance and merely consumption in another, and often the motives will be quite mixed. A commercial artist buys paints and brushes to use in making his living. Another person may buy the same articles as playthings for his children, or to cultivate a hobby of his own. Even the professional artist may use some of his materials for things he intends or hopes to sell, and some on work done purely for his own pleasure. In another instance, moreover, the same items may represent investment in training for earning activity later on.

The latter instance suggests that there is something quite arbitrary

even about the distinction between consumption and accumulation. On the face of it, this is not important for the definition of income; but it must be remembered that accumulation or investment provides a basis for expense deductions in the future, while consumption does not. The distinction in question can be made somewhat definite if one adopts the drastic expedient of treating all outlays for augmenting personal earning capacity as consumption. This expedient has little more than empty, formal, legalistic justification. On the other hand, one does well to accept, here as elsewhere, a loss of relevance or adequacy as the necessary cost of an essential definiteness. It would require some temerity to propose recognition of depreciation or depletion in the measurement of personal-service incomes—if only because the determination of the base, upon which to apply depreciation rates, presents a simply fantastic problem. It is better simply to recognize the limitations of measurable personal income for purposes of certain comparisons (e.g., by granting special credits to personal-service incomes under income taxes).

Criticizing Professor Irving Fisher's view that savings should not be treated as income, Simons observes (in part) as follows: *

Indeed, the whole distinction between consumption and saving may well be expressed in terms not of individual purpose but rather of social consequences of different employments of purchasing power. One tends to conserve and augment productive capacity; the other involves loss and destruction of economic goods. One person secures self-expression by increasing his wealth at a prodigious rate; another, by making his business the largest in the community; another, by providing the finest cultural opportunities for his children; another, by traveling the world over. Many people save mainly because it is the thing to do, because it is expected of them. Certainly, the accumulation of property is often, if not typically, motivated by desires of the same order as those expressed in invidious consumption. In a world where capital accumulation proceeds as it does now, there is something sadly inadequate about the idea of saving as postponed consumption.

All this is perhaps relevant to the much argued question: Are savings income? Not only is it gratuitous, for our purposes, to divide goods into those yielding pleasurable sensations and those which are intermediate but, if these words mean anything at all, it seems hard to deny that acquisition of property rights may mean increase of power, greater freedom, security, prestige, and respectability. These are as much objectives of endeavor as are lapels on one's coat or diamonds on shirt fronts. Income implies achievement of certain objectives; and these achievements we propose to measure by the impartial judgment of the market. The market asserts that property rights are just property rights, whether they permit one's eating eggs or clipping coupons. Likewise, the market values additional resources just as it values vegetables; and the economic cir-

* *Personal Income Taxation*, pp. 96–98.

cumstances of him who owns either is measured in terms of prices or values. Why he may have bought claims to future goods, services, or funds, rather than that which he might eat or drink at the moment, the market does not inquire.

To ask whether savings are income suggests again the disposition to think of income in terms of things. Saving is accomplished by certain uses of purchasing power; savings are expenditure (if we disregard monetary disturbances of hoarding and dishoarding). Income is not saved or spent; it is rather a measure of saving and consumption together. To maintain that savings are not income is not illogical, however, if one is willing to go the whole way and define income as a concept already nicely covered by the word "consumption." If savings are not income, then depreciation is not negative income; and all gain connotations must be abandoned. This, Fisher is willing to do.

The problem here is only that of choice among verbal symbols. However, it seems a hardly debatable proposition that usage is already too firmly established to permit our accepting Fisher's proposal and eschewing the gain implications of income,[4] even were there something to be gained thereby. His proposal comes all too tardily in the history of our language; and his pleas have been, and must be, without effect upon our courts, legislatures, accountants,[5] and men of affairs—not to mention the economists.

[4] This rather commonplace view is nicely expressed in C. Colin, *La Notion du revenu* (Paris, 1924): "En somme, si nous pouvons trouver chez Irving Fisher certains points de détails propres à nous aide dans nos recherches, il nous est impossible de lui demander un corps de doctrine auquel on puisse se référer absolument. Il a élaboré une idée qui lui est propre du capital et du revenu, sa conception, logique du reste avec elle-même, a cependant le grave défaut de ne s'accorder ni avec les idées économique ni avec les idées courantes, elle reste donc, en quelque sorte, 'en dehors,' et à quelque point de vue que l'on se place dans cette étude ne peut nous apporter que confusion" (p. 19).

[5] Professor Canning has said a great many nice things about Fisher's work; and he believes, or at least asserts, that it is of immense potential importance for accounting. He points out that *if* an accountant *were* measuring consumption he would come out as does Fisher; he asserts that assets have never previously been adequately defined; and he observes that accountants and directors should give thought to the consumption requirements of stockholders in deciding upon dividend policy. These not very illuminating points aside, I fail to see that Canning has even made any contact between accounting problems and Professor Fisher's work; but both the author and Fisher seem to feel otherwise on that score. Incidentally, considerable space is given to problems of depreciation measurement! (Canning, *op. cit.*)

Several Views Concerning the Taxation of Cooperatives

THE problem of defining income involves the mooted question of how the income tax should be applied to cooperatives. The issues in this field have been analyzed by the editor as follows: *

In taxing cooperatives, the application of corporate and personal income taxes to patronage dividends is the point of major difficulty and confusion. A rebate (patronage dividend) to customers may be conceived as a retroactive price adjustment not representing income to the distributor. On this theory, the cooperative is an agency for increasing the bargaining power of its patrons. The cooperative charges or pays tentative or nominal prices subject to adjustment through a rebate, the latter determining the effective prices. If gains based on nominal prices, taking no account of effective prices, were subject to tax in the hands of the cooperative, the gain could be avoided by cutting the nominal to the effective price. In other words, cooperative pricing could be at cost, so that the business would have no patronage dividends to distribute. This would be inconvenient for the cooperative and contrary to its tradition opposing price wars.

In the case of the personal income tax, patronage dividends on production goods (those used in creating income) would seem to be properly included in the tax base of customers. If a farmer buys a tractor at a bargain through a cooperative, his expenses of production will be reduced and this will augment his income from farming. Wisdom and shrewdness in buying are often a factor in income. On the other hand, patronage dividends on consumption goods (those used in the consumption of income) purchased by the final consumer would seem to be improperly included in the tax base of the customer. Thus, if a farmer buys groceries at a bargain he is merely reducing his cost of living. Cost of living expenses are not deductible, although a personal credit approximating average cost of maintenance, perhaps, is allowed. Buying at a bargain is a way open for all to beat the exemption. Income arises from selling goods dear, not from buying them cheap.

Most of those who accept the view that a patronage dividend is a retroactive price cut would concede one limitation to its application. Where a cooperative does a substantial business with nonmembers and distributes only to members, the distribution takes on the aspect of dividing profits. It is conceded also that dividends to stockholders according to investment, or the reinvestment of earnings which might later be so distributed, does not differ from similar

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procedures by noncooperative business. However, reinvestment may be earmarked (through stock dividends to purchasers) for ultimate distribution as patronage dividends, and in this case it does not differ substantially from a current patronage dividend.

The legal status of farm cooperatives in the light of recent court decisions is discussed by R. Wayne Newton, Manager, National Association of Cooperatives, as follows: *

There are, at present, two plans for taxing cooperatives. All but farmer cooperatives, and a large number of these as well, are taxed under the same general provisions of law as all other corporations. The remaining farmer cooperatives have elected to qualify for exemption under sec. 101 (12) of the Internal Revenue Code. Since this exemption concerns only part of one class of cooperatives, it will promote clarity of thought if we consider first the tax status of the general body of cooperatives, those taxed under the general provisions of the income tax law.

If cooperatives could forecast all expenses, with unerring accuracy, and could pre-determine their own exact business volumes, it would then be possible to quote prices to patrons that would result in their operating exactly at cost. No one has yet suggested that any net income would be realized or that any tax liability would accrue under such conditions. Neither has anyone seriously suggested that such a plan is practical in the business world of today.

Many cooperatives do closely approach this ideal, however. Some act only as commission merchants or bargaining agencies. All funds except their commission charges are transferred direct, from or to the account of the patrons, as the case may be, with the co-op acting only as agent. Others make monthly or quarterly adjustments of their mark-ups so that any excess or deficit is always small and easily adjusted in the next period. A third plan is to make a fixed charge upon all members without regard to their patronage and to pay all overhead charges from these funds, after which each patron pays only the wholesale or manufacturers' price for all items purchased from the co-op.

A more difficult problem faces farmer marketing co-ops dealing in products which are produced upon a seasonal basis but are marketed in a relatively even flow throughout the whole year. When the potato, grain, bean or wool grower places his product in an elevator or warehouse his crop becomes co-mingled with that of all other patrons. Every sale that is made is a sale, in part, of his interest. He cannot know his exact share of the total sales price, less handling costs, until the whole crop has been sold.

The patron usually receives a partial-payment when he delivers his crop, but a very sizeable additional sum will have accumulated in the hands of the cooperative during the course of the marketing year. It is this sum which is commonly referred to by competitors as being profit, and

* *1945 Proceedings,* National Tax Association, pp. 272–274.

as morally liable to income tax as it would be if it were the income of a private dealer.

Here we meet the issue underlying the whole problem of cooperatives and the income tax; does, or does not, the surplus in the hands of the co-op constitute income to the co-op? It has been the practice of the Treasury to offer no objection to the deduction from income of the usual refunds by such non-profit agencies to their patrons.

This policy appears to have been over-ruled by the Tax Court in the case of United Cooperatives vs. Commissioner about one year ago. In this case patronage refunds, made in compliance with terms set up in the articles of incorporation and by-laws of the co-op, were held deductible from income as sums owing to patrons under the terms of their contracts of purchase. Additional refunds were held to be distributions of corporate income, however, since they were not owing under the contracts implied from the articles and by-laws. On this point, the court said:

> We conclude that petitioner's patrons were entitled by reason of its by-laws to that part of the so-called patronage dividends distributed to them which was in excess of eight percent of the par value of petitioner's common stock outstanding and to that extent these patronage dividends were properly excluded from the taxable income of petitioner. However, that part of these patronage dividends which could have been distributed in the discretion of petitioner's board of directors as dividends upon petitioner's common stock must be considered as the property of petitioner and taxable to it as its income.

It seems clear from the *United* case that the patronage refunds of a non-exempt cooperative are not income, and not taxable as such, where the refunding is made in fulfillment of a definite contractual obligation arising from the terms of the original patronage agreement. Where the co-op has bargained away its right to the property even before it ever came into possession of it, it never held title, except as agent. Mere inability to determine the exact value of the property in advance of the closing of its books does not alter the fact that the patron's title is above question and attaches from the moment the property comes into the possession of the co-op.

The opinion is widely held that this decision rules out the prevailing practice by which non-exempt co-ops have postponed the determination of what part of their net savings would be credited to patrons until the end of the patronage period. The exercise of such discretionary authority by the co-op seems to establish the taxable character of these refunds under the United decision.

The United decision also suggests that the courts may take cognizance of the manner in which cooperatives discharge their claimed liabilities to patrons in determining whether the relation of debtor and creditor was real, or was only a subterfuge to avoid tax liability. Under the articles of incorporation and by-laws of this non-exempt farmer cooperative, the major patrons were obligated to periodically adjust their individual holdings of common stock so that these holdings would be in proportion to their annual business volume. It was further provided that patronage refunds payable to patrons would be applied first to the consummation of any stock purchases made obligatory by this provision. The court, after ascertaining that the terms of the ar-

ticles and by-laws were known to the patrons, held that the effect was no different than if the refunds had been paid out in cash and then returned as investments. It would appear, however, that if this withholding of patronage refunds had been made without the authorization of the patron, it would have been construed as discrediting the claim that the funds were the property of the patrons and might have rendered them subject to taxation as the income of the cooperative.

The view that cooperatives enjoy special tax privileges which should be removed is defended by Ben C. McCabe, President, National Tax Equality Association, as follows: *

Cooperatives claim that patronage dividends represent "savings" or "rebates" or "discounts" or "net margins" or "over-deposits," belonging to members and patrons, and that they are not profits. Under the terms of existing laws the Treasury Department has recognized this claim and has ruled patronage dividends excludable from federal income tax in the hands of a cooperative corporation.

Taxpaying businessmen contest this claim, pointing out, first, that patronage dividends represent money earned by the same processes of buying, selling and manufacturing as in the case of a regular corporation, a partnership or an individual proprietorship; and, second, that the taxability of earnings should be determined by the way those earnings are created, and not by the disposition that is made of them.

Actually, the present deductibility of patronage dividends is based on a complete misunderstanding of the true nature of the profit distributions made by cooperatives. In their early beginnings most cooperatives operated on a true non-profit basis—that is, their operations fell within the purview of mutual trading, or their operations were carried on through delegation of the members' powers to an agent.

Tax-wise they have continued to claim sanctuary from taxes on this basis, though businesswise the doctrines of mutuality and agency have been cast to the four winds.

Nowhere in the mechanical organization or plan of operation of a present-day cooperative are there any elements that, from the standpoint of logic and economics, would differentiate it tax-wise from a regular corporation.

A cooperative corporation is a separate legal and business entity, doing business in its own name, suing and being sued, just like an ordinary corporation for profit. It realizes the opportunity of making a profit from the combining of resources of many individuals, like any other corporation. A cooperative corporation establishes for its owners freedom from personal liability for loss.

The current cooperative claim that because dividends are taxable in the hands of recipients, profits may not also be taxed in the hands of the corporation, falls of its own weight in view of the existing "double taxation" of corporate income. Such

* *Ibid.*, pp. 281–283.

double taxation may constitute an inequity, but it is in accordance with the law of the land and to fail to enforce the law on cooperatives, too, is to create an inequality and an undue preference for one form of business at the expense of another.

A cooperative may, under certain circumstances, act as a true agent in performing services for individuals, but a true agent acts for each principal in each transaction on an individual basis. When profits and losses on numerous individual transactions are mingled and the individuals share alike in the profits, the concept of agency is lost.

A true agent must realize no profits from investments of capital, neither can it use capital which represents current contributions of its joint principals. The deferment for a time of the distribution of funds creates capital, which, if used by the agent, results in profits. This, too, is in abrogation of the agent-principal relation.

In most cooperatives the element of continuing liability of the principals is absent when the cooperative suffers losses in its operation. In such instances the cooperative reverts to and avails itself of the limited liability of a regular business corporation. Obviously no corporation should be permitted to claim a corporate status when it is advantageous to do so and an agency relation when that form of business better suits its purpose.

In actual present-day operations of marketing cooperatives, the losses on the produce of one member are normally offset against the profits of another. In this way many members receive distributions which, according to the theory of agency, belong to others. The same is true of purchasing cooperatives, since all articles purchased by the individual members come out of a common inventory. The profits derived from particular purchases or sales, or losses sustained as a result of such transactions, are commingled, and their identity is lost. This violates the fundamental principles of agency.

Patronage dividends, in most instances, include profits arising from investments or the use of capital. Such gains are in the nature of true profits accruing to the cooperative corporation through the use of capital assets. The distribution of such revenues alters the concept of agent and principal.

In the matter of reserve accumulations, the agency concept is also usually transgressed. Reserves are derived by the retention of a portion of the gain arising from the individual's transaction. In a true agency all gains must be immediately turned back to the principal and must be fully accounted for by the agent. Such reserves are normally invested in facilities whose title rests in the cooperative.

The accumulation of these nontaxed patronage dividends is the basis for the current enormous growth of cooperative corporations.

Instead of paying these patronage dividends in cash, it is common practice for a cooperative corporation to go through the motions of selling preferred stock or other evidences of equity to members and patrons, and thus to retain the cash as additional capital or reserves for the operation and expansion of the business.

In such sales the member-owner has no option. Nor can he, in most instances, sell his stock or participation certificates, or in any other way realize whatever cash value they may

have, until the management of the cooperative corporation permits him to do so.

Total accumulations of this sort run into many hundreds of millions of dollars.

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ERWIN N. GRISWOLD

Collection at the Source

THE income tax is generally rated high as to equity but it is not easily administered. Difficulty of administration is much increased by extending the tax to cover smaller incomes. Among the devices used to facilitate administration and to accomplish other important objectives is collection at the source. This device was introduced into the American law during World War II. Some of the objectives and difficulties of its introduction were explained by Professor Erwin N. Griswold, tax consultant to the Secretary of Treasury, in an address before the California State Chamber of Commerce, December 2, 1942, as follows: *

How can we develop our revenue law so as to produce this needed additional revenue? One of the first things which needs consideration is the improvement of the present structure of our system. Until a few years ago, the income tax was essentially a class tax. It reached only a small proportion of our population. Now it has become a mass tax. More than 27 million persons will be paying tax on their 1942 incomes and that number will increase substantially when the new Victory tax goes into force next January. This presents an enormous problem in the collection of the tax which we have not yet adequately faced and solved.

Under the present law none of the tax on incomes received in 1942 is due until March 15, 1943, and then in installments through December 15, 1943, more than a year away. Over one-third of the persons who will owe this tax have never paid an income tax before. It requires no great foresight to see that the problem of collecting taxes from all of these persons is going to be very large. The amounts which they will have to pay will in many cases be larger than they have ever had to meet before.

Let us examine for a moment the amount of tax liability which is imposed by the current Revenue Act of

* Unpublished.

1942. There are exemptions, below which no tax is imposed. These amount to $500 in the case of a single person, and $1200 for a married couple, and there is $350 additional exemption for each child below the age of eighteen and for certain other dependents. In most cases, these exemptions represent very minimum subsistence levels. There are many places in the country where it may be doubted whether a person can maintain himself on as little as $500 a year. And $1200 a year does not allow any extravagances for a married couple.

Once these exemptions are used up, then each additional dollar of income is taxed under the new law at the rate of nineteen per cent, that is, the 6% normal tax, and 13% in the first bracket of the surtax. The surtax rates rise rapidly, and the combined normal and surtax rates exceed 50% of any additional amounts of income over $18,000. But it is incomes below that amount in which we are primarily interested. Under the present law, a housemaid who earned $16 a week in 1942 will owe an income tax next year of $50, or almost a dollar a week. A married man with two children and a salary of $3,000 a year in 1942 will owe $159, or more than 5% of his income. In addition, each will pay a Victory tax of 5% on 1943 income in excess of $624. It will be extremely hard for many persons to meet liabilities of this sort. Quite apart from the question of deliberate evasion, there will be many persons who simply will not have the money available when liability for this year's taxes rolls around next year. It will be possible to make some adjustments, to allow extensions of time, to make provision for payment of the taxes in installments. But when we are dealing with millions of taxpayers, it is obvious that the administrative problem in making such adjustments will be very large.

Both for the protection of the revenues and as a definite means of convenience and assistance for the great mass of small taxpayers, we must develop an effective and efficient system for collecting a large part of the income tax liability at the source. The tax should be taken out of the wage earner's wages before the money is paid to him. This is not only the surest way to get the money; it is also the most painless way for most taxpayers to pay the tax. It will not be nearly as hard for them not to spend what they do not get as it is to try to save for an indefinite and distant tax liability.

The new tax law makes a start in this direction with the so-called Victory tax. This is an additional tax of 5% which is to be collected in the year 1943, and is to be collected at source from wage payments. But this does not go far enough. It leaves the full amount of the income tax outstanding as a liability, and thus, indeed, serves to make the problem harder, as it leaves the wage earner with less money for the payment of his regular income tax liability. To achieve the result that is really needed, the collection-at-the-source device must be extended so that it covers as much as possible of the income tax liability.

There are many difficulties to be overcome in the establishment of a collection-at-the-source system. The problem of administration will be considerable for the Government, and the burden thrown upon em-

ployers is undeniable. This is in part due to the conviction that any tax collected at the source should not be a gross tax, but should make a proper allowance for an exemption and for dependents. That means that a portion of the wages should be payable without withholding, and that only the excess should be subject to tax. This involves a calculation in the case of each employee, and it is not possible to apply a flat percentage to all of the wages as is done with the social security tax payments.

But there are further difficulties with the collection-at-the-source plan which are even greater. Perhaps the most serious arises from the fact that there are large sections of our population who are not wage earners and who would not be reached by a system of collection at the source no matter how complete and efficient it might be. The classes who do not receive their income in the form of wages include farmers, many small business men, and professional people. There is also the very large group of domestic employees, who do receive wages, but with respect to whom the collection-at-the-source system would be very difficult to apply. The only way that has been devised to deal with the non-wage-earners is to require them to file quarterly returns with a corresponding payment of tax. This obviously greatly increases the paper work which they would be required to do. The only alternative would seem to be to let these persons continue on the old basis. But this would mean giving up entirely the benefits of collections at the source as applied to this large section of the population, and it would also mean some discrimination against the wage earners who were required to pay their taxes in advance through collection at the source. Perhaps the domestic employee problem could be taken care of by the application of some system of tax stamps which the employer could buy and paste into a book which the employee would file to show the proper payment of the tax. But the problem of the many members of the population who are not wage earners remains with us, and presents a real difficulty which is usually not faced by those who say that the solution of all our difficulties lies in the development of a system of collection at the source.

The difficulty with collection at the source which has received perhaps the most attention is the one that is known as the "hump." This is the problem that arises in a year of transition to collection at the source. If no adjustment is made in the year of change, then two years' taxes will be payable in one, and this would be an impossible burden for many taxpayers. They would have to pay last year's taxes out of this year's income, at the same time that this year's taxes were being withheld out of this year's wages. With tax rates at the present level many thousands of taxpayers could never meet the burden. It is in connection with this situation that the so-called Ruml plan has its greatest possibilities.

The Ruml plan was advanced by Mr. Beardsley Ruml, the Treasurer of Macy's store in New York, and also Chairman of the Federal Reserve Bank of New York. The plan as he has advanced it calls for the elimination of one year's taxes in order to put all taxpayers on a current basis. In its original form, when applied to all taxes, the Ruml plan

has a serious defect, in that it gives an unwarranted bonanza to the big incomes. But if confined to the normal tax and the first bracket of surtax, the Ruml plan gives us a means of instituting collection at the source which would enable us to put about 85% of all our taxpayers upon a substantially current basis. We could for example reduce tax rates on income received in 1943 by 20 percentage points, and then start collection at the source at the rate of 20% above exemptions on January 1, 1944. It is too bad that such a plan could not have been made effective January 1, 1943, but that chance seems to have escaped us now.

The indications are that some developments along the lines of an increased collection at the source will take place during the coming year. Changes in the law to this end are badly needed to make our tax collections as efficient and as fair as they may be made. We should not overlook the fact that collection at the source is the standard way of collecting much of the wartime income tax liability in most other countries.

Views and Recommendations Concerning the Taxation of Capital Gains and Losses

CONSIDERING next the application of the income tax to corporations and their security holders, we are confronted first by the problem of how capital gains and losses (usually gains or losses incidental to the sale of securities or real estate) should be treated. Both in practice and opinion wide variations concerning this issue are apparent. Three views are presented here. The first consists of certain recommendations made by a Twentieth Century Fund Study in 1937: *

* * * *

(2) The Committee recommends that, in place of the undistributed profits tax, individuals be required by law to value their shareholdings each year and enter the plus or minus difference for the year in their personal income tax returns, provided the practical difficulties of administration can be overcome.

The value of the stockholder's shares can be computed in two ways: (1) If the stock is listed, the market value as of the end of the year could be used. (2) In the case of unlisted stocks, each corporation might be re-

* Reprinted by permission from *Facing the Tax Problem* (New York: Twentieth Century Fund, 1937), pp. 477–479; 482–483; 488–490.

quired to report to its stockholders the percentage change in book value of each share during the year, and the stockholder might then be required to adjust the value declared the year before up or down by that percentage. Because either the market value or the book value of stock will reflect the degree to which profits have been undistributed, or losses sustained—as well as any increase or decrease in the value of assets from other causes—the stockholder will thus be put upon the same basis of tax justice as the partner and individual owner.

In the case of stock sold during any year the seller would report the realized capital gain or loss represented by the difference between the reported value at the end of the previous year (or the purchase price, if the stock was bought during the same year) and the selling price. The purchaser would use the purchase price as the base with which he would compare the value of his holdings at the end of the year—or the realized gain or loss if sold before the year's end. Some adjustment would, of course, have to be made with respect to the year when such a compulsory inventorying method of taxation was put into effect, in order to deal with securities that had already been held over a period of years.

(3) We also recommend that, in applying this inventory plan, the capital losses in any one year that are in excess of capital gains for the same year be deducted from other income, and, if there is any excess remaining, this excess be carried forward and deducted from income of all kinds in tax returns of future years until it is entirely absorbed.

The Committee is fully aware of the many administrative difficulties and other problems involved in this inventory plan. For example, the end-of-the-year price for a security with a thin market may not furnish a fair measure of value, and even an active market may not provide an adequate basis for valuation if the block of securities in question is very large. Then, too, the tax might lead some closely held corporations to delist their securities. The use of book values to determine for tax purposes the inventory value of unlisted securities might result in injustice to taxpayers in the event of sudden write-ups or write-downs of corporate assets, and in the event of financial reorganizations that drastically change the stated book value of a corporation's securities without involving any change in their actual values.

A more fundamental objection to nearly all methods of taxing capital gains is that it is unfair to tax a gain that merely reflects a change in the general price level. This criticism holds that a dollar gain is only a "real gain" to the extent that it exceeds the rise in the price level during the period over which it was held, and that taxation of capital gains should recognize this fact.

To state these difficulties, however, is not to imply that they cannot be overcome. The Committee believes that an unremitting effort should be made to devise some practicable plan by which annual changes in the accrued value of stockholdings can be reflected in the stockholder's income tax returns.

(4) The Committee further recommends that, to insure against the possible unconstitutionality of a law that taxes capital gains on an accrual basis, a constitutional amendment be

initiated at once to ensure the legality of this particular form of income taxation by the federal and state governments.[1]

* * * *

(6) The Committee recommends that, whether the compulsory inventorying method or some alternative is adopted, consideration be given to devising machinery for distinguishing the capital increase or decrease due to a change in price level from real capital increase or decrease. While minor changes in price level are not important, if a substantial inflation or deflation were to occur, it would be highly desirable to adopt some method whereby the portion of the dollar increase or decrease in capital value due to change in price level could be eliminated for tax purposes and only the real capital increase or decrease taken into consideration.

(7) The Committee also recommends that the income tax law be amended so that any untaxed increase in the value of a person's security holdings that exists at the time of his death shall not escape taxation, as it does under the present law. If the compulsory inventorying method is adopted, it could be made applicable to a decedent's estate with respect to the appreciation existing at the time of death. If some alternative method is adopted, some technical difficulties arise; but, in substance, a plan could be worked out whereby the cost to the decedent would be the basis for computing gain or loss upon subsequent sale by the estate or a beneficiary. Similarly, a decrease in the value of the holdings that exists at death should be allowed as a deduction. If the deduction should be in excess of the decedent's other income, some provision would be necessary for reducing the estate tax or for making the allowance effective in some other way.

* * * *

The Justice of Capital Gains Taxation

We believe that capital gains often represent real increases in taxpaying ability, and capital losses, real decreases. The only question is whether the income tax is the proper place to take account of these changes in taxpaying ability.

Of course, capital gains that result merely from a change in the general price level are not real gains in economic power. It has been suggested that for this reason capital gains in general should be taxed at a low rate. However, this creates gross inequality between the recipient of a true capital gain and the recipient of a salary. The question is thus one of balancing the various advantages and disadvantages. No method of taxing capital gains can be completely satisfactory.

A separate tax for capital gains, with a separate rate, splits taxpaying ability into two isolated compartments. (A taxpayer with a large income from other sources—salary, interest, dividends—and with a small income from capital gains, would pay a small tax on his gains. Actually, a taxpayer is not a bundle of isolated abilities to pay) (One great fault of the present tax system as a whole is that it levies upon a given taxpayer too many separate items, which are not related to each other

[1] The Supreme Court has ruled in a somewhat similar situation that an individual's "income" is not affected by changes in the value of his holdings until a "separation" actually occurs through a sale or exchange of his stock.

or to the taxpayer's total net ability to pay.)

The present capital loss provision is a case in point. By refusing to allow the deduction of capital losses from ordinary income (except for the $2,000 allowance), the tax law implies that any capital loss in excess of a capital gain does not reduce the taxpayer's ability to pay.

oss is not indemnified

Capital gains and losses do require particular treatment within the income tax structure. The chief difficulty is the injustice that follows the concentration of many years' gain in the taxable income of a single year. Owing to the progressive rate scale of the surtax, a larger tax than otherwise must be paid. The present percentage provisions, reducing the gain or loss according to length of time held, are, of course, an imperfect adjustment to meet this problem.

The Influence of Capital Gains Taxes on Speculation

It is often claimed that in prosperous times the owners of securities, commodities, and real estate fail to sell when they should—and otherwise would—because of the taxation of capital gains. The fact that they will have to pay a heavy tax on the profit that they will realize is said to deter them from selling. The result is claimed to be over-extended speculative positions, inordinate rises in prices, and ultimate collapse.

This argument, however, has little foundation—at least in logic—if it is assumed that rates will remain the same in future years. If the owner thinks that the security will go still higher, he should keep it, regardless of the tax. If he thinks that it is going lower, it will pay him to sell, as long as the tax is less than 100 per cent. If he does not know what to think, he would still not know what to think even if there were no taxation of capital gains.

Of course he saves interest by delaying payment of the tax. He may also gamble on the chance that rates will be reduced, or that the tax will be repealed. Moreover, the capital gains provisions of the present federal revenue law, which place a progressively heavier tax the shorter the period during which the asset has been held, do have the effect of deterring the sale of assets when a profit rather than a loss has been accrued. This is particularly true when the owner may become subject to a tax on a smaller percentage of his total profits by holding the asset for only a short additional period. These qualifications do not, however, touch the main theme of the argument as it is usually presented.

But it must be admitted in partial answer to the argument that investors and speculators often do act irrationally. That fact must be taken into account in formulating tax policy.

Several alternative means of taxing capital gains were also considered by the committee as possible substitutes for the main recommendation stated above.

The views of Emil Schram, president of the New York Stock Exchange, were presented to the House Committee on Ways and Means: *

* *Hearings on Revenue Revision of 1942* (Washington: American Taxpayers Association, Inc., April 1942), pp. 15–17.

The Chairman. State your name and whom you represent, for the record, Mr. Schram?

Mr. Schram. My name is Emil Schram. I am president of the New York Stock Exchange. My address is 11 Wall Street.

The Chairman. You may proceed.

Mr. Schram. You have heard a great deal of opinion and testimony of a technical nature relating to the capital-gains tax in the course of these hearings. I want to take a few minutes to discuss with you the general philosophy of this tax, as I see it. Having but recently left the Government service, I think I can look at this problem in a somewhat detached manner and from the point of view of those of you whose responsibility it is to provide revenue in increasingly large amounts for the conduct of the war.

Considering the overwhelming burden imposed upon the Treasury and the Federal credit by the necessities of war financing, it would be utterly foolish for anyone to propose at this time any change in the capital-gains tax which did not promise greater revenue to the Government. Both the proponents and the opponents of the capital-gains tax provisions agree that the paramount purpose is to raise revenue. I want to show you why I think the present capital-gains tax has defeated its own purpose as a revenue-raising measure. Because I recognize the imperative emergency need of revenue, I will not discuss the unsoundness of the principle of the capital-gains tax. That discussion, in my judgment, can be left to a more appropriate time. At the moment all of us are concerned above everything else with the problem of financing the war. What I have to say bears directly upon that problem.

It seems to me that there are but two reasons why people invest their capital. Either they invest to obtain an income by way of rents, dividends, or interest, or they invest with the hope that they may sell the investment at a profit. Unless taxpayers are willing to buy and sell capital assets, there is no possibility of deriving revenue from a capital-gains tax.

No man in his right mind is going to expose his hard-earned capital to needless risks. The income accruing by way of rents, dividends, or interest cannot compensate for the loss of capital. In earlier years an investor who lost his capital in one venture had at least a chance of recouping his loss in a subsequent venture. Today the capital-gains tax has made this extremely difficult, if not impossible.

To illustrate, take the case of a taxpayer who has accumulated $10,000 capital. He invests $5,000 of it in a piece of land and the other $5,000 in a local manufacturing company. Over a period of years the local manufacturing company prospers and the taxpayer sells this investment at a profit of $3,000. The next year he sells his land at a loss of $3,000.

Now you would think that this taxpayer, having made $3,000 in one venture and having lost $3,000 in another, would still have his $10,000 in capital intact. But under the present capital-gains tax this might not be the case. The chances are the taxpayer would have shared a large portion of his capital gain with the Government, but would have borne all of the loss himself. This means that a taxpayer's capital is going to be

frittered away even though he is skillful enough to balance his successful and unsuccessful investments.

Under existing circumstances it is easy to see why business investments no longer attract private capital to the extent that they should in a healthy economy and why there is such a lack of much needed venture capital. This lack of venture capital has, I believe, increased the financial burden which the defense effort has placed upon our Government. I have no doubt that all of you know businessmen in your districts who have been forced either to borrow from the Government or from the banks in order to finance their war efforts, although those businessmen would have preferred to finance themselves through the raising of equity capital.

Time and time again I have heard people say, "I know that this is a sound venture and I know that it needs equity money, but I won't go into it because if it succeeds, I will have to give most of my gain to the Government, while if it fails, I will have to bear all the losses myself."

It seems to me that those who urge a higher capital-gains tax lose sight of the very important and very fundamental fact that you cannot derive revenue from a capital-gains tax unless you have purchases and sales of capital assets. I think it is demonstrable that the high capital-gains tax has been an important factor in discouraging people from making capital investments. In addition, it has discouraged those with profits from realizing them.

practice

I am convinced that the lowering of the capital-gains tax will free equity capital and, by so doing, will not only help to shift a portion of the financing of the defense effort from Government to private capital, but also to increase the revenue derived from the capital-gains tax itself.

The Government's own records demonstrate that the capital-gains provisions, as now written, are disappointing from the standpoint of revenue produced. Not only is there a large loss of potential revenue to the Government, but we have a paralyzing condition of inertia, insofar as the use of venture capital is concerned.

The question has been raised as to the relation of speculation to the proposed modification of the present capital-gains tax. The statement has been made that the bill proposed by Congressman Boland "would place a premium on speculation." It seems to me that such an effort to discredit the proposed improvement in the tax law is not only deplorable, but that it misses the point.

This country has benefited greatly from speculation of a constructive character. One type of speculation which contributes to the general economic welfare, and which is thus socially desirable, is that engaged in by informed people who can afford to assume risks. Such speculation is often, in reality, an investment in the future of the country. Without that kind of speculation, this country would not have witnessed the development of the Curtiss-Wright Corporation, the Chrysler Corporation, United States Steel Corporation, and other great enterprises which are today producing the materials with which we are going to win the war.

Let me point out that the effects of the capital-gains tax extend far beyond the securities markets. It hits every landowner and every businessman who makes a capital investment of any kind. Its chilling effect is as

great on the price of farm lands and other real estate as it is on securities listed on the New York Stock Exchange.

I earnestly believe that the good which will come to the country as a whole from a lowering of the present capital-gains tax will far exceed any benefit which our securities markets may derive, and that much more revenue will be realized in the aggregate from a lower tax than from the present one whose principal effect, as I see it, is to destroy incentive.

MR. BOLAND. I just want to elaborate on the statement that you made a few seconds ago. You are very emphatic in your statement that this bill of mine does not place a premium upon speculation?

MR. SCHRAM. It certainly does not, in my opinion.

MR. BOLAND. The statement made by the Treasury along that line is very emphatic that it does.

MR. SCHRAM. I cannot agree with them at all.

MR. BOLAND. That is all.

The view of Professor Henry Simons follows: *

To eliminate both capital gains and losses in computing taxable income, however, would simply prohibit fairness in relative levies among persons. To do this, or even to make the more moderate concessions of our federal law, is to undermine the very basis of income taxation. Proponents of such measures would have us go but a little way toward modifying the penalty of progression upon irregularity, at the cost of abandoning effort to reach individuals according to their relative income circumstances. They would persist in the attempt to treat income taxes as *ad rem* levies—an error less serious, by the way, with respect to the English tax of the last century. It should require little insight to appreciate the folly of allowing for irregularity of personal income through exemption, or special treatment, of particular kinds of receipts. The income tax is properly a tax upon persons according to income; and it loses something of its *raison d'être* whenever distinction is made among kinds of "income," gains, or receipts. Moreover, special treatment of certain kinds of gains or receipts goes a very small way toward reducing irregularity of personal income; and, in this instance, it displays solicitude for a small group whose "rights" are properly not an object of serious concern.

Any special treatment of capital gains per se also requires introduction into the law of arbitrary, unsatisfactory, and unnecessary distinctions. In America we say that "capital assets" shall mean property other than "stock in trade." Gain or loss from the sale of such assets is capital gain or loss. Strikingly similar are the definitions of the *Reichseinkommensteuer*. The English inspector (and courts) must decide whether the transactions in question are a part of the taxpayer's ordinary business—whether they have to do with vocation or avocation! That such definitions must lead to strange results from the viewpoint of equity is immediately obvious; that their mitigation of tax inequities which arise from income-instability is pitifully

* Reprinted by permission from *Personal Income Taxation*, pp. 151–154.

meager, seems also beyond argument. Nor do they simplify the task of administration.

Special treatment of capital gains is especially objectionable for the opportunities which it provides for deliberate evasion or avoidance. It might well stimulate issue of bonds at low nominal rates and heavy discount—or at least lead to concentration of such issues in the hands of persons subject to the higher rates of tax. Companies might even find it advantageous to issue bonds without annual interest, for investors liquidating in advance of maturity could claim the blessings of section 117. Furthermore, one sees here important incentive to restriction of corporate dividends or to infrequent distribution—which would permit substantial avoidance if stockholders were to liquidate in advance of distributions. With the rise of specialized investment trusts, the possibilities here are of no small proportions. "Convert your income into capital gains" may well become a potent slogan for security salesmen of the future.

The case in favor of some allowance for the irregularity of taxable income, however, is strong, for prevailing methods of measurement do aggravate the inequities. The real culprit here is the realization criterion. Gains and losses from capital transactions are recognized only when the investor "gets out." One may complain of this practice; but to demand that it be abandoned outright is to display little regard for practical considerations. Escape from it is possible in the case of actively traded securities; but, unfortunately, the realization criterion must be accepted as a practical necessity. What, then, can be done to provide the desired relief?

It requires some temerity to propose additional administrative complications. Yet relief can perhaps be provided for highly unstable incomes without serious imposition on the treasury. Would it not be possible to introduce some modification of the averaging system? The earlier English procedure under Schedule D had appeal even for those who urged its abandonment; and it seems that something may well be salvaged from it for the future. A specific proposal may at least suggest possibilities.

Let each individual be taxed annually as heretofore. Then, say in 1940, let him compute his average taxable income for the years 1935–39, inclusive. Next, let him compute what his total taxes would have been if his average income had been his actual income for each year. Then, if this amount is less than the total of his five actual payments by more than 10 per cent, let him claim rebate for the excess over 10 per cent. The percentage margin is introduced to keep the number of claims within reason—though apology might be made on broader grounds; and the exact figure should be fixed with regard to questions of administrative cost. The period chosen is likewise arbitrary. If it be very long, relief will come too tardily. If it be very short, the average loses significance and the number of claims is needlessly increased. Considerations of simplicity also argue for the use of fixed periods, opportunity to file claims being granted simultaneously to all taxpayers, say, every fifth year.

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ROSWELL MAGILL

The Taxability of Stock Dividends

THE problem of taxing capital gains is related to that of taxing stock dividends. The latter consist of payments in the stock of the corporation distributing them. Often a corporation reinvests its earnings in new equipment and then distributes stock in lieu of cash. The tax status of such receipts has proved a highly difficult question for the Supreme Court. The evolution of legal doctrine in this field is discussed by Roswell Magill as follows: *

With this background, the Court approached the problem of *Eisner* v. *Macomber*.[1] The 1916 Act in its definition of income specifically included stock dividends to the extent of the cash value thereof. The Standard Oil Co. of California had 500,000 shares outstanding out of an authorized capital stock of 1,000,000 shares. It had a surplus of $45,000,000. In 1916 the company declared a 50% stock dividend and transferred from surplus account to capital stock account an amount equivalent to the stock issue. The plaintiff, a stockholder, received some of the new shares as a dividend. She was taxed on that part of the value of the dividend shares which represented corporate profits earned after March 1, 1913, the effective date of the Sixteenth Amendment. Having paid the tax under protest, she brought this action to recover it, on the ground that a stock dividend was not income within the meaning of the Sixteenth Amendment; and that the tax violated the provisions of the Constitution[2] requiring direct taxes to be apportioned according to population. A general demurrer by the Collector was overruled on the authority of *Towne* v. *Eisner;* and to review this judgment, a writ of error was prosecuted. The Supreme Court affirmed this judgment in a five-to-four decision. The reasoning of the majority, briefly stated, is as follows:

1. *Towne* v. *Eisner,* in which a unanimous court declared that stock dividends were not intended by Congress to be taxed as income in the 1913 Act, is controlling, for the reasons advanced therein are equally applicable to this case. The Court had there said:[3]

"A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished and their interests are not in-

[1] 252 U.S. 189, 40 Sup. Ct. 189 (1920).

[2] Art. I, Sec. 2, cl. 3; Art. I, Sec. 9, cl. 4.

[3] 245 U.S. 418, at 426.

* Reprinted by permission from *Taxable Income* (New York: The Ronald Press Company, 1936), pp. 29–34; pp. 45–49.

creased. . . . The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones." . . . In short, the corporation is no poorer and the stockholder is no richer than they were before. . . . What has happened is that the plaintiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new.

2. An examination of the constitutional question confirms the conclusion that a stock dividend is not income. Income, to be taxable, must be realized. A stock dividend is not a realization of income; it is "merely bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities; it affects only the form, not the essence, of the 'liability' acknowledged by the corporation to its own shareholders, and this through a readjustment of accounts on one side of the balance sheet only, increasing 'capital stock' at the expense of 'surplus'; it does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share."[4]

"The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment."[5]

"We are clear that not only does a stock dividend really take nothing from the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction."[6]

3. While a stockholder may sell the new shares, to do so results in a loss of voting power and a decrease in capital interest. "Yet, without selling, the shareholders, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax."[7]

[4] Eisner *v.* Macomber, 252 U.S., at 210, 211, 40 Sup. Ct., at 194.

[5] *Ibid.*, at 211, 40 Sup. Ct., at 194.

[6] *Ibid.*, at 212, 40 Sup. Ct., at 195.

[7] *Ibid.*, at 213, 40 Sup. Ct., at 195. In answer to the government's contention that the new certificates measure the extent to which the gains accumulated by the corporation have enriched the stockholder, the Court said, at 214, that "enrichment through increase in value of capital investment is not income in any proper meaning of the term." The government had also argued, as an alternative contention to the one that a stock

4. A stock dividend does not accurately measure the extent to which a particular stockholder has been enriched by the operations of the company. "Secondly, and more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term." [8]

The Court thereupon concluded that "neither under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder." [9]

The dissenting opinions adopted two attacks, each characteristic of the justice writing the opinion. Mr. Justice Holmes said: [10]

I think that *Towne* v. *Eisner* . . . was right in its reasoning and result and that on sound principles the stock dividend in that case was not income. But it was clearly intimated in that case that the construction of the statute then before the Court might be different from that of

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dividend is income, that the tax was levied, not on the stock dividend as income, but on the stockholder's share of the corporation's previously accumulated undivided profits, as manifested by the dividend. But the Court replied, at 217, that such a tax would be "taxation of property because of ownership" and would require apportionment under Art. 1, Sec. 2, cl. 3 of the Constitution. Collector *v.* Hubbard, 12 Wall. 1 (1870) which held a stockholder taxable under an Income Tax Act on the earnings of a corporation, must be regarded as overruled by Pollock *v.* Farmers' Loan & Trust Co., 158 U.S. 601, 15 Sup. Ct. 912 (1895).

[8] *Ibid.*, at 214, 215. This idea is well expressed by Lord Finlay in Commissioners of Inland Revenue *v.* Blott [1921] 2 A.C. 171, 8 Tax Cas. 101, 133 (in which the House of Lords arrived at a similar conclusion under the British income tax act): "Did he" [the shareholder] "get anything in the nature of payment of income? It is obvious that he did not. He gave up any claim to the income. What might have been paid as income went to increase the capital of the company. The shareholder got his proportionate share in the business of the company as increased by the additional capital. The proportion of his share in that business as compared with the proportions of other shareholders was in no way affected by the issue of the preference shares, as all the shareholders alike got them. The benefit, and the sole benefit, which the respondent derived was that the business in which he had a share was a larger one with more capital embarked in it, precisely as might have been the case if the accumulated profits had been applied in the improvement of the company's works and machinery."

[9] *Ibid.*, at 219. The Court assumed that the tax here imposed was a direct tax, and thus unconstitutional unless saved by the Sixteenth Amendment. Prof. T. R. Powell has criticized this aspect of the decision. He argues that the receipt of a stock dividend is the subject of indirect taxation, especially since it is not in the class of recurring gains which usually form the objects of a direct tax. Powell, Constitutional Aspects of Federal Income Taxation, in the Federal Income Tax (Columbia University Lectures, 1921), pp. 51, 87. The decision may be supported, however, on the ground that, while a separate tax on stock dividends might be indirect, the value of such a dividend cannot be included in the assessment of an income tax proper.

In Commissioners of Inland Revenue *v.* Blott, cited in the previous note, several of the judges in the House of Lords referred to Mr. Justice Pitney's "luminous reasoning," and "most interesting and instructive judgment" with approval. The British act did not, however, in terms tax a stock dividend. The House of Lords distinguished Swan Brewery Co., Ltd. *v.* The King, [1914] A.C. 231, arising under the Dividend Duties Act, 1902, of Western Australia on the ground that the statute in that case defined "dividend" to include "every profit, advantage or gain intended to be paid or credited to or distributed among the members of the company," and that the new shares were "advantages." Distinctions between the tests applied in the Blott decision and later English decisions; and those of Eisner *v.* Macomber are considered in (1926) 75 U. of Pa. L. Rev. 158.

[10] *Ibid.*, at 219, 40 Sup. Ct., at 197. Mr. Justice Day concurred in this dissent.

the Constitution. . . .[11] I think that the word "incomes" in the Sixteenth Amendment should be read in "a sense most obvious to the common understanding at the time of its adoption." . . . For it was for public adoption that it was proposed. . . . The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest.

Mr. Justice Brandeis chose to meet the majority on their own ground. He argued: [12]

1. Corporations retain corporate profits, and yet effect a distribution, in two ways: the declaration of a stock dividend: or an increase in capital stock accompanied by a cash dividend equal in amount, with an option in the stockholder to use the latter in payment of the stock. The two are substantially identical, the second produces taxable income: why not the first? But as Professor Powell observes, the majority's contention that a stock dividend is substantially identical to no dividend is equally valid.[13]

2. "The term 'income' when applied to the investment of the stockholder in a corporation, had, before the adoption of the Sixteenth Amendment, been commonly understood to mean the returns from time to time received by the stockholder from gains or earnings of the corporation. A dividend received by a stockholder from a corporation may be either in distribution of capital assets or in distribution of profits. Whether it is the one or the other is in no way affected by the medium in which it is paid, nor by the method or means through which the particular thing distributed as a dividend was procured. . . . It seems to me clear, therefore, that Congress possesses the power which it exercised to make dividends representing profits, taxable as income, whether the medium in which the dividend is paid be cash or stock, and that it may define, as it has done, what dividends representing profits shall be deemed income." [14]

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2. *Dividends in Securities Differing from Those Previously Held*

Eisner v. *Macomber* dealt with a dividend of common stock to a common stockholder.[15] Hence, there was

[11] Mr. Justice Holmes said in Towne *v.* Eisner, 245 U.S. 418, 425, 38 Sup. Ct., at 159: "But it is not necessarily true that income means the same thing in the Constitution and the act. A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used." As Prof. T. R. Powell aptly remarked: "The word proved to be a crystal after all, but only by a five-to-four vote." Powell, "Constitutional Aspects of Federal Income Taxation," *The Federal Income Tax* (Columbia University Lectures, 1921), pp. 69. 70.

[12] 252 U.S., at 220, 40 Sup. Ct., at 198. Mr. Justice Clarke concurred in the dissent.

[13] Income from Corporate Dividends, (1922) 35 Harv. L. Rev. 363, 378. The majority also argued that the case of an actual cash dividend coupled with an option to purchase stock is distinguishable in that the stockholder has actually received something of value, severed from the corporation, and placed at his disposal.

[14] 252 U.S., at 226, 237, 238.

[15] Similarly, in the converse situation where all stockholders surrender equally some of their stock to the corporation, no loss results, as the remaining shares absorb the value inherent in the surrendered shares. Scoville *v.* Com'r, 18 B.T.A. 261 (1929) (here preferred stockholders, but there was no evidence as to the terms of the stock or capital structure of the corporation); cf. Burdick *v.* Com'r, 59 F. (2d) 395 (C.C.A. 3d, 1932), aff'g 20 B.T.A. 742.

no decision specifically upon the questions of the taxability of dividends to preferred stockholders in common stock or in preferred stock; dividends to common stockholders in preferred stock; or dividends in bonds to common or preferred stockholders. The first of these questions finally reached the Supreme Court sixteen years after *Eisner* v. *Macomber;* the remaining questions have so far been dealt with only by lower courts.

Shortly after the decision in *Eisner* v. *Macomber,* Congress inserted in the Revenue Act of 1921 a new provision: "A stock dividend shall not be subject to tax"; which was retained until 1936 without change.[16] The Treasury gave this subdivision a broad interpretation; the current regulations provide in Art. 115–8: "The issuance of its own stock by a corporation as a dividend to its shareholders does not result in taxable income to such shareholders." As a corollary, the Regulations have provided in substance that if the new stock received as a dividend is of a character or preference materially different from the old stock, the cost of the old stock shall be apportioned between the old and the new.[17]

Thus taking the statute and regulations together, there was reasonable ground for the contention that any dividend paid in stock of the declaring corporation was exempt; that the law in substance so declared, and, if the law was ambiguous, the long-continued administrative regulation established the true construction.

Two Circuit Courts of Appeals reached opposite results in cases of dividends of common stock to holders of cumulative non-voting preferred stock.[18] In each case the stockholder had sold some of his holdings. The Treasury's theory was that the dividend was tax-free; that therefore the cost of the stock originally held should be apportioned between the old and new shares; and the gain on the sale determined accordingly. The taxpayers contended that the dividend was taxable, under *Eisner* v. *Macomber;* that the basis for determining gain or loss on a sale of the dividend shares was therefore their value at the time received; and that the old shares retained as their basis their full cost, with no allocation to the new shares.

The Supreme Court upheld the taxpayer's contention in *Koshland* v. *Helvering,*[19] saying:

> Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old,—the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old,—does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment. Whether Congress has taxed it as of the time of its receipt is immaterial for present purposes.

Mrs. Koshland, the taxpayer, had sold the preferred stock upon which

[16] Sec. 201 (d) of the 1921 law; Sec. 201 (f) of the 1924 and 1926 laws; Sec. 115 (f) of the 1928, 1932, and 1934 laws.

[17] Reg. 86, Art. 113 (a) (12)–1 (2).

[18] Tillotson Mfg. Co. *v.* Com'r, 76 F. (2d) 189 (C.C.A. 6th, 1935), affirming 27 B.T.A. 913 (1933); Com'r *v.* Koshland, 81 F. (2d) 641 (C.C.A. 9th, 1936), rev'g 30 B.T.A. 1462 (1934); (1936) 45 Yale L.J. 1122.

[19] 297 U.S.—, 56 Sup. Ct. 767 (1936).

the dividend had been declared. The Court held that, under the plain terms of the basis provisions of the law (Section 111 (a) and 113 of the 1928 Act), she was entitled to deduct its full cost in determining her profit.

The first proposition advanced by the Court—that *Eisner* v. *Macomber* does not require a holding that a dividend of common stock paid on non-voting preferred stock is exempt from income taxation—is clearly correct. The preferred stockholder has received the new and separate rights of a common stockholder—increased participation in dividends and in assets upon liquidation, and voting rights.[20] *Marr* v. *United States,*[21] considered in detail below, indicates that these new rights constitute income to the shareholder; and that the presence or absence of outgo from the corporation is not an essential factor. The last sentence of the quoted passage from the *Koshland* case is significant. The statutory exemption is not specific, but it seems unlikely that Congress in fact intended to exempt any dividend that is constitutionally taxable as income. Nevertheless, the repeated re-enactment of the statutory exemption, following the liberal Treasury interpretation of it, may well be held to have conferred an exemption upon any dividend in stock of the declaring corporation. Congress has now made its purpose clear, by providing in Section 115 (f) (1) of the Revenue Act of 1936: "A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

By the same token, if a preferred stockholder receives a dividend in preferred stock, he has received more than he possessed before, mainly, the right to more dividends and greater participation on liquidation. In addition, the corporation has altered its relation to the stockholders, in that it has accepted an added obligation. Such a dividend should be held taxable under *Eisner* v. *Macomber*.

Where a stockholder receives a dividend in the form of bonds of the declaring corporation, he has been held taxable on their fair market value.[22] The stockholder has ob-

[20] *Cf.* Brown *v.* Com'r, 69 F. (2d) 602 (C.C.A. 7th, 1934), aff'g 26 B.T.A. 901 (1932). Here a corporation, owned by two stockholders, had outstanding only common stock. It declared a dividend in preferred stock. The Board held the dividend was a stock dividend, as the term is used in section 201 (g) of the 1926 Act, discussed *infra,* in which section it probably has the same meaning as in section 115 (f). The dividend was a mere proliferation of existing interests and the proportionate rights remained the same. That each now held preferred as well as common stock was without significance. Note, however, that while the rights of the mass of stockholders remained the same, each stockholder possessed new rights—those of the preferred stockholder. Before, these advantages depended on combined action by the two stockholders; after the dividend this was not necessary. *Cf.* Torrens *v.* Com'r, note 76, *infra. Cf.* also May *v.* Com'r, 26 B.T.A. 1413 (1932), in which it was apparently assumed that preferred stock received by common stockholders was a stock dividend.

[21] 268 U.S. 536, 45 Sup. Ct. 575 (1925), discussed in paragraph division 5 of this chapter.

[22] Doerschuck *v.* United States, 274 Fed. 739 (E.D.N.Y. 1921); United States *v.* Fuller, 42 F. (2d) 471 (E.D. Pa. 1930) (bonds issued against entire accumulated surplus ($600,000) are only income to extent of fair market value at time ($468,000). *Cf.* Oxford Paper Co. *v.* United States, 52 F. (2d) 1008 (Ct. Cl. 1931), 56 F. (2d) 895 (Ct. Cl. 1932), in which a taxpayer was held to sustain a loss

tained something different in kind from what he possessed before—he is a creditor now, as well as an owner.[23] *Marr* v. *United States*[24] recognized that gain may be realized on the acquisition of an essentially different interest in the same enterprise. The traditional cleavage between bondholder and stockholder will satisfy the test of "essential difference." But, realistically, *Eisner* v. *Macomber,* as Justice Brandeis pointed out in his dissent[25] in that case, is not so easily distinguished. In each case there has been a segregation of the surplus profits in a legal sense and the evidences of this segregation have been given to the stockholder. Further, some writers have urged that, as a result of the "corporate revolution" the economic position of many stockholders today does not materially differ from that of a bondholder.[26] It is probably still true, however, that the recipient of a dividend in bonds would regard himself as having received something severed from his original investment, and differing essentially from it.

on the exchange of first mortgage bonds for preferred stock of the same corporation.

The British view is *contra.* See Whitmore *v.* Com'rs, 10 Tax Cas. 645 (K.B. 1925); Com'rs *v.* Fisher's Exrs., [1926] A.C. 395, 10 Tax Cas. 302, 333. In the latter case, the Lord Chancellor (Cave) said: "The company was, therefore, master of the situation, and it elected definitely and irrevocably not to distribute the fund as income, but to impound and apply it as income-producing capital; and that election, if made (as I do not doubt that it was made) in good faith, was binding on the shareholders and could not be questioned by the Crown." This view is criticized in (1926) 75 U. of Pa. L. Rev. 158, 163: ". . . if what the shareholder receives is immediately convertible into cash without loss of his share of company control, it is taxable as income." *Cf.* Torrens *v.* Com'r, 31 B.T.A. 787 (1934).

[23] *Cf.* Commercial Trust Co. *v.* Com'r. 8 B.T.A. 1138 (1927), where a taxpayer exchanged bonds, cash, and notes for stock on a reorganization and the Board stressed the difference in the nature of the securities.

[24] Cited *supra,* note 20.

[25] 252 U.S. 189, 220, 229, 40 Sup. Ct., at 201.

[26] Berle and Means, *The Modern Corporation and Private Property* (1932), pp. 279–280.

32

HAROLD M. GROVES

Personal Versus Corporate Income Taxes

THE income tax may be applied to corporations as well as individuals. A levy on corporations may be merely a collection at the source (in which case the individual stockholder is credited with the tax on his personal account) or it may be a tax on the corporation as such. Taxa-

tion of corporations as such, along with individuals, involves special problems concerning which the editor has written as follows: *

I. *Rationale of Business Taxes*

The rationale of a tax may seem to be of little consequence. Its incidence and economic effects may appear much more important. However, the effects of a tax depend somewhat upon the reasonableness of its imposition. Arbitrary taxes are likely to be injurious to morale.

Analysis of the rationale of a tax usually starts with a consideration of benefits and of ability to pay. As to benefits, it can be argued that business receives from government a desirable milieu in which to conduct its operations. Certainly, business could not thrive in the anarchy that would prevail without government; but neither could the wage earner, professional man, nor any other citizen. The fallacy lies in the fact that relative benefits are indeterminate. The benefit theory offers support for taxation in general, but it provides no satisfactory clue as to how taxes should be distributed. It is impossible to say in what degree various taxpayers benefit from a battleship.

In a sense, a business institution is an entity distinct from its owners. It can be conceived as an "organic unity," acting in a single capacity and receiving benefits from government in the course of this activity. However, it is as logical to identify this entity with its wage earners, creditors, and customers as with its owners. In this conception, everyone "belongs" to many such entities. But everyone bears some part of the business-tax load also, for the incidence (final burden) of business levies is probably not confined to the owners. The amount each person does and should bear, however, cannot be definitely determined.

The benefit theory has further limitations as a justification of the corporate net income tax. This tax takes no account of the fact that whether or not they show a net profit, corporations enjoy the favorable environment of government.

A personal tax considers the obligation of the taxpayer in the light of his duties as a citizen. A business tax approaches him in terms of "government as a factor of production." It is interesting that the factors of production—land, labor, capital, management, and government—are all, with the exception of the latter, employed voluntarily by the businessman. The amount of government and the apportionment of its cost to business are determined by voting. However, in the voting process, business (directly at least) has a minority voice.

In the last analysis, all taxes come out of the income or capital (actual or potential) of individuals. Tax burdens cannot be borne by inanimate objects. Will division among individuals be more equitable or otherwise more desirable if business taxes are levied? This is the important question, and, in searching for the answer, one gets little guidance from a consideration of benefits.

* Papers and Proceedings of the Fifty-eighth Annual Meeting of the American Economic Association, *American Economic Review*, XXXVI, No. 2 (May 1946), pp. 241–49. Reprinted by permission of the American Economic Association, Evanston, Ill. For a contrary view see Selection 49, Chap. 6.

Closely related to the benefit analysis is the contention that corporate taxes are justified as payment for the special privilege of operating as limited liability associations. Under modern corporation laws, however, the privilege is available for the asking. If competition were effective, the value of the privilege would be reduced to zero. It is true that competition is not that efficient, but corporate taxes make no pretense of measuring the results of monopolistic practices. Moreover, the states, not the federal government, grant most corporation franchises.

The second main support for the corporate income tax is that business entities have ability to pay independent of that of their stockholders. Difficulties here become apparent when the theory is given specific application. For example, if ability to pay is to serve as the basis of a corporate tax, can we properly ignore the ratio of earnings to capital invested? If the answer is negative, we are forced into the field of excess profits taxation, where the problem is one of due allowance for efficiency and risk.

Any corporate tax is necessarily impersonal in character and makes no differentiation among stockholders according to income status. The small stockholder, sometimes mainly dependent upon a small income from stocks, is subject to the same treatment as the wealthy investor.

It can be argued, of course, that the corporate income tax does represent a progressive element in the tax system because it is paid mainly by rich people. All studies of dividend distribution point to the conclusion that such income tends to much concentration in the higher brackets of income. This involves the question of incidence, which will be discussed presently. Assuming that the incidence of the corporate levy is on the stockholders, its progressive character is bound to be highly capricious. A truly progressive tax will not only assess a $25,000 income more than a $5,000 income, but it will assess *all* incomes of the higher level at a higher rate. The corporate tax results in a higher tax on dividends than on salaries, bond interest, or capital gains, regardless of quantitative aspects. The test of taxation which it applies is qualitative rather than quantitative. To contend that a tax is desirable merely because it is paid by the wealthy exemplifies the kind of irresponsibility which threatens the successful operation of a mixed economy.

It is true, of course, that certain other taxes, such as the levy on whiskey, are sometimes justified because they are paid mainly by the rich. The whiskey tax can be supported on the ground that the consumption of strong liquor should be discouraged. But as a means of making the rich support the government, its incidence is even more capricious than a levy on corporations. A recipient of a $100,000 income is hardly less able to pay taxes to the government than another of the same means merely because the former dislikes whiskey and the latter gives it a high rating in his budget.

The situation is complicated by the fact that many people believe there is something immoral about profits—especially corporate profits—which justifies singling them out for special taxation. This is associated with the idea that all business is more or less a racket. Unfortunately, there is more basis for this conviction than one would wish. But

probably the salary paid the manager of a racketeering business is as immoral as the profits paid the stockholders. The fact that profit income is noncontractual and contingent hardly gives it a moral inferiority. Although there are many rackets connected with business, other fields, including even religion, are not immune.

There is also a conviction, and a much more legitimate one, that unearned income (from property) should pay more taxes than earned income (from services). However, a distinction on this score can be made most consistently at the personal level in a differentiation of the personal tax. As a matter of fact, even a differential tax on profits could be incorporated in the personal tax. Ignoring the problem of undistributed profits (for the present) it can be said that all property and income are attached sooner or later to individuals, and there are no sound objectives of taxation that cannot be achieved with a personal tax system. That it is possible to make the tax system more progressive, even with the elimination of the corporate tax as such, is not open to serious question. Available means to this end are a reduction of sales taxes, a strengthening of the death tax, and plugging the loopholes in the personal income tax.

II. *Incidence*

Thus far our discussion has been predicated on the assumption most favorable to the corporate tax; namely, that its incidence is on the stockholders. But there is strong ground for the belief that, especially over long periods of time, a considerable part of this tax burden is diffused among consumers, wage earners, and recipients of other investment income. For example, the British have levied few or no peacetime business taxes; yet it seems improbable that rates of profit in Great Britain are higher than here or higher than they would have been had the tax system featured business taxes. The old idea that an old tax is no tax is not entirely without application to the corporate income tax field.

It is true that corporate income taxes are based upon a surplus—in one sense. The net tax is not a cost of doing business as a gross tax would be. On the other hand, profits are not all a *social* surplus in the sense that enterprise would be forthcoming without them. If some profit is necessary to draw out a supply of enterprise, it follows that any tax on the rewards of enterprise may affect the supply and that this may in turn affect output and prices.

Corporate taxes may also be diffused among investors. A special tax on one line of investment tends to check the flow of capital in that direction, resulting in higher rewards to investment there; the increased supply of funds in other fields reduces the rewards to those investments. Thus the levy might amount to an unearned income tax.

Two conclusions concerning the incidence of the corporate net income tax follow. One is that the factor of uncertainty regarding the ultimate burden of the tax is in itself a strong point against the tax. The second is that insofar as the tax is shifted forward it becomes a sales tax in disguise, having all the regressive features usually associated with the sales tax family.

It may be argued, of course, that the incidence of the personal tax is

as uncertain as that of the corporate levy. However, this is not convincing. The personal tax is levied on the individual in his role as citizen and is a highly differentiated levy. It is extremely doubtful that this tax has any great effect on the supply of the factors of production.

III. *Economic Effects*

As to economic effects, it is apparent, first, that the corporate tax discriminates against corporations which finance with equity capital as compared with those that finance in part with bonded indebtedness. A dollar of income earmarked for the bondholder is paid to him in full, but a profit dollar earmarked for the stockholder is, in effect, cut to about sixty cents. The extent to which this affects the pattern of corporate financing is disputed, but the influence, whatever its degree, is clearly on the wrong side. Business instability is enhanced by excessive corporate debt.

The second approach to economic effects is through the factor of incentives. The author has argued that a tax close to the productive process and within the range of managerial discretion is likely to have more weight in decisions concerning business expansion than a more remote levy on stockholders. However, the main issue is not whether taxes at the corporate level are more of a deterrent than taxes at the personal level. The issue is whether singling out the profit element in income, regardless of distribution, for especially heavy taxation is a deterrent to risk-taking investment. The question, put this way, seems almost to answer itself.

Our present tax system applies two taxes to profits, one to bond interest, less than a full tax to capital gains, and none at all to the interest from many government bonds. Again it is important to point out that these are qualitative, not quantitative distinctions. If taxes are a deterrent to whatever they strike, as commonly supposed, it can hardly fail to follow that these perverse distinctions offer some discouragement to the assumption of risks.

The present combination of taxes also tends to encourage "corporate hoarding." The quantity of saving depends upon two conditions: the ability to save and the will to save. The corporate tax might diminish the ability to save, but the double tax feature attending it affords an extremely strong incentive to save. The present system provides a differential tax burden favorable to undistributed as contrasted with distributed earnings. Profits that pass through corporations are subject to two levies; earnings that are reinvested, to only one. It is a well-known fact that the increase in dividend distributions during the war was far less than the increase in corporate earnings. The cures for this perversity are not easy to apply. Obviously, the first to suggest itself is an undistributed profits tax in place of the corporate net income tax.

IV. *Social Control*

Turning next to the use of the corporate tax for social control, perhaps the strongest case built on this theme asserts that the corporate tax is a means of recapturing unjust enrichment arising from monopoly in business and that it is used, or might be used, to prevent monopoly. But is it good policy to tax all profits (or even all so-called "excess" profits) in the endeavor to tax monopoly prof-

its? Monopoly profits can be taxed at the personal as well as the corporate level. If a corporate tax were to be designed for preventing monopoly, it would need to be graduated at the upper rather than at the lower level. A case could be made for such a tax, which, however, would be painfully undiscriminating.

It is true, of course, that a graduated corporate tax like our own gives a differential advantage to small business and that the social interest in small business is real and important. There are, however, other ways of using the tax system to aid small business. Since this subject is to be discussed by other speakers on the program, I shall not venture further with it here.

V. *Fiscal Necessity*

We come now to perhaps the strongest argument for the retention of a corporate business tax in the federal tax system. Certain practical limitations of personal income and death taxes, combined with high fiscal requirements, dictate the conclusion that not all the needed revenue can be had from sources approved without reservation.

The personal net income tax is subject to two limitations, the first of which is administrative. It has not been demonstrated as yet that we can apply a direct tax with high rates to large numbers of low-income farmers, professional men, and individual businessmen. The second limitation is political. It has not been demonstrated that we have the discipline to maintain the breadth of base and the high, effective rates necessary to make a direct tax supply all of our revenue needs. Strong pressure to raise exemptions is based on the theory that exemptions should be accommodated, not to revenue needs, but to some absolute standard of living. The proponents ignore the facts that governments supply prime necessities of life, too; that one way or another these will be paid for in part by families with incomes below the national average; and that the income tax is the fairest way to collect from such families. There is now and has always been a battle between opportunism and rationality in taxation, and a complete victory for rationality would be too much to expect.

Perhaps the various taxes should accordingly be rated in priority order. In such a scale, personal income and death taxes would rate at the top and general sales taxes at the bottom. Corporate net income taxes would rank well above most special excises. The latter are quite as arbitrary in their incidence as the corporate income tax and have the additional undesirable feature that they tend to undermine the highly important postwar market.

Another pertinent point is that several state and local taxes, including the general property tax, are subject to many of the objections here raised against the corporate income tax and to other limitations as well. An overhauling of these revenue sources is long overdue.

THE COMMITTEE OF THE NATIONAL TAX ASSOCIATION, ROBERT MURRAY HAIG, CHAIRMAN

Excerpt from the Report on the Tax Treatment of Undistributed Profits

PROBABLY the most difficult problem in the application of the income tax to corporate business is the treatment of undistributed profits. A special committee of the National Tax Association, appointed to deal with this problem, reported, in part, as follows: *

Methods of Reaching Individual Interests in Corporate Savings

The various methods of attacking the problem fall within the scope of four main types. Deferring until later our expression of conclusions and recommendations regarding the immediate program that should be adopted in this country, we here present an analysis of the possible alternative courses of action.

Later we also appraise a method, employed for years by our revenue acts but recently given special emphasis, which taxes certain corporate savings not by virtue of their character as savings but by virtue of the motive that is supposed to have led to their accumulation, namely, the purpose to avoid surtaxes. Much the larger portion of corporate savings is, of course, not subjected to this tax.

The Inventory Method

The accretion concept of income, carried to its logical extreme, takes into account every factor affecting the increase or diminution in the economic strength of the individual between two points of time. One important factor in the case of the typical taxpayer is the amount of profits made by any business in which he may have an interest. Even if these profits be not physically distributed to the taxpayer, their existence will presumably be reflected in the value of his interest. Consequently, by comparing the values of his interest at the beginning and at the end of his taxable year, it should be possible to secure a figure which fairly represents the improvement of the economic position of the taxpayer so far as his ownership interest in the business is concerned. Undivided

* *1939 Proceedings,* National Tax Association, pp. 544–554.

profits will have registered their effect, as will also any other significant factor affecting the position and prospects of the business. It follows that, if the value of the beneficial interests of taxpayers in business concerns, whether incorporated or unincorporated, could be accurately appraised at regular intervals, it would be possible to ignore all the business entities and to deal only with individual interests, which would be regularly inventoried on a market value basis.

The inventory method, above described, is a method that offers, in theory, a completely satisfactory and precise solution to the problem of applying the personal income tax to the undivided profits of corporations,[1] but it is a method that accomplishes at the same time much more than this, for it registers the effect not only of undistributed profits but of every other significant factor affecting the interest as well. It cuts cleanly through all the complications by completely ignoring the business entity and by dealing only with values of individual equities. These values, as established in the market for ownership interests in all types of businesses, incorporated or unincorporated, should give a result which would place all forms of ownership organization on an equality under the tax and would achieve complete equivalence of the tax base, tax rate and time. Incidentally they should also provide a solution of the general problem of capital gains and losses.

Unfortunately, however, the theoretically perfect results above described cannot be anticipated in actual practice. The troublesome fact is that the accuracy of the results is a function of the accuracy of the values available and, under present conditions, it is impossible to secure a comprehensive set of perfect valuation figures for all beneficial interests, either by inference from market quotations or by the technical appraisals of the expert. Within a large portion of the field, it is true, fairly dependable data are readily available, but whenever the interests are not represented by securities dealt in actively on the organized exchanges, it would be necessary to proceed with tentative and approximate valuations which would invite argument and manipulation.

In one instance the present revenue acts permit the use of the inventory method. Dealers in securities are permitted to inventory "at market" the securities which constitute their stock-in-trade. Changes in equities in general are in effect taken into consideration only in closed capital transactions where gains and losses are recognized. This postponement of accountability until definite legal realization occurs brings changes in equities to account only sporadically and not at regular intervals, and is the feature that makes it impossible to depend more heavily upon the capital gains tax as a solution of the problem of the taxation of undivided profits. When realiza-

[1] An exception to this statement is encountered in case it is desired to preserve the identity of certain items of income (such as tax-exempt interest) received by the entity. To do so, it would be necessary to deal with the entity to the extent of securing from it the data necessary for the allocation, among the beneficial owners, of the item of income to which it is desired to give special treatment. It should be particularly noted that when the term "inventory method" is used, it is assumed that market values will be assigned to all items, and that such rates as "cost or market whichever is lower" will not be utilized.

tion can be indefinitely postponed, equivalence, whether of base, rate or time, is completely destroyed. In essence the inventory method proposes that capital gains be taxed at regular rather than at irregular intervals.

Incidentally, twenty-four years ago a committee of this Association, of distinguished membership,[2] recommended that ordinary investors, as well as dealers, be given the privilege of inventorying their holdings. Any such partial application of the method, however substantial its contribution may be toward the solution of the capital gains problem, does not make it possible to ignore the business entity and to rely completely on capital gains taxation as a solution of the problem of reaching corporate savings for personal income tax purposes.

In addition to the fact that the inventory method is practically unavailable for use in a comprehensive manner because of the lack of dependable periodical valuations of the equities involved, there is also doubt of its availability on legal grounds. The committee hazards no opinion as to the position which the Supreme Court would take if the issue were to be squarely presented to them at this time, but it recognizes that, in the light of previous decisions, the compulsory and comprehensive application of the inventory method might require a constitutional amendment.[3] So far as our information extends, no country has made comprehensive use of the method as a solution of the corporate savings problem.[4]

The Partnership Method

If the inventory method on a comprehensive scale be conceded to be unworkable under present conditions, the next most attractive approach from the point of view of theory, is essentially the device long used in this country in the case of partnerships, namely, individual taxation of the distributive shares of the corporate profits whether distributed or not. In contrast with the inventory method (which deals with the reflection, in the value of the shareholder's equity, of the current earnings of the corporation, as modified by the reflection of any other significant factors that may be present), the partnership method merely attempts to make certain that each year each owner's aliquot share of the corporation's current earnings is fully taken up in the individual personal income tax return. Other factors affecting the value of the stockholder's equity are ignored until the stock is disposed of. By applying to the corporation the exact method used in the case of the partnership and the individual entrepreneur, precise equivalence of treatment as among the various types of ownership organization is assured.

Here again there are great diffi-

[2] The members were: Edwin R. A. Seligman (chairman), T. S. Adams, C. J. Bullock, A. E. Holcomb, G. E. Holmes, K. K. Kennan, R. H. Montgomery and A. C. Rearick. *1915 Proceedings,* National Tax Association, p. 303 ff.

[3] "The conclusion of the matter is, then, that the Supreme Court has not regarded an unrealized appreciation in value of corporate stock as being income to the shareholder." Roswell Magill, *Taxable Income,* p. 40.

[4] Under the law of April 6, 1932, the Kanton Basel-Stadt, in Switzerland, permitted taxpayers, by declaration, to bring to account, for income tax purposes, gains and losses in the value of real estate and securities. Otto Deppe, *Finanz Archiv,* XLVIII (1931), 2. In 1934 this privilege was withdrawn as regards losses.

culties. A method that may without difficulty be applied to a partnership with a half-dozen beneficial owners is not so easily applied to a corporation with 100,000 beneficial owners. Moreover the corporate structure is typically more complicated than the partnership structure and the task of assigning the undistributed earnings to the proper parties in interest is sometimes extremely involved. Finally, partnership interests are sold with relative infrequency as compared with blocks of stock; [5] when a partner sells out, the calculation of the gain or loss, upon the closing of the transaction, involves a computation giving effect to the taxes he may have paid upon his share of undistributed profits passing to a new owner and a similar calculation would be necessary in the case of sales of stock.

As with the inventory method, the legality of the partnership method, applied on a compulsory and comprehensive basis, is not free from doubt. While, under a Civil War statute, the Supreme Court clearly held that it was "as competent for Congress to tax annual gains and profits before they are divided among the holders of the stocks as afterwards . . . ," [6] it declared in 1920 [7] that this position had been overruled by the Pollock case.[8] Language used by the Supreme Court in the recent National Grocery Company case [9] has led some to believe that if the issue were presented afresh to the Court at this juncture, the pronouncement would uphold the power of Congress to apply the partnership method to corporations in general. Other competent lawyers disagree. Consequently, the possibility that a Constitutional amendment might be required to render available the general application of the partnership method should be recognized. On the other hand its application on an optional basis or as a device to prevent avoidance should be legal.

Except for our own Civil War precedent, the use of the partnership method on a comprehensive scale to solve the problem of applying the personal income tax to corporate savings seems not to have been attempted.[10] Nevertheless it has been used with success to cover a very substantial area of the corporate field in various foreign countries, notably Australia.[11]

[5] The difficulties arising from changes of ownership of stock can be minimized by requiring the allocation of undistributed profits to owners as of a date fixed in the statute, a device now used in the consent dividends credit and foreign personal holding provisions of the Revenue Act.

[6] Collector *v.* Hubbard, 12 Wall. 1 (1870).

[7] Eisner *v.* Macomber, 40 Sup. Ct. 189 (1920).

[8] Pollock *v.* Farmers' Loan & Trust Co., 158 U.S. 601, 627, 628, 637.

[9] 304 U.S. 282.

[10] However, partial and restricted use of the partnership method has been resorted to in various federal revenue acts, e.g. in section 228 of the Revenue Act of 1918, in section 104 (d) of the Revenue Act of 1928 (continued in the Revenue Act of 1932) and in the "consent dividend" provisions of the present statute (Revenue Act of 1938, section 28).

[11] In Australia a private company, that is "a company that is under the control of not more than seven persons and which is not a company in which the public are substantially interested," must distribute, within nine months of the close of its taxable year, all of its investment income and at least two-thirds of its other "distributable income." Otherwise it is subjected to the "partnership method," the tax being payable by the corporation and the amount being "the aggregate additional amount of tax which would have been payable to its stock-

The Compulsory Distribution Method

The third approach consists of a forced distribution of corporate earnings to the shareholders. In its extreme form this method applies pressure upon the corporations by an arbitrary prescription or by means of penalties sufficiently heavy to compel them to pass out promptly every dollar of their earnings to their shareholders, in whose hands they will then be subjected to the full impact of the rate scale of the personal income tax. The essence of the method is pressure, and the pressure theoretically demanded is of a degree sufficiently great to accomplish its object completely; if the pressure is exerted through a tax, it should be a penalty tax which no corporation would ever pay.

So far as the distribution of the tax burden is concerned, this compulsory distribution method might under certain conditions achieve precisely the same results as the partnership method discussed above. The shareholder receives his full share of the corporate earnings and pays the same tax as though, under the partnership method, he had received a notice giving him the amount of his "distributive" share.[12] Both methods could thus give precisely the same results with respect to the maintenance of the identity of income and of equivalence of base, rate and time.

It should be clearly noted that, so far as this primary question of the apportionment of taxes is concerned, the compulsory distribution method need not necessarily mean that the dividends be declared in cash. Such distribution might conceivably be made in one or more of four methods: (a) cash dividends, (b) stock dividends payable in a kind of stock different from that already owned by the stockholder, (c) stock dividends payable in stock of the same kind as that already held by the stockholder, (d) information certificates advising each stockholder (and the government) of his share of the undistributed earnings. The objections to compulsory cash dividends are obvious. The present apparent legal requirement that stock dividends, to be taxable income to the stockholders, must be paid in stock of a kind different from that already held by the stockholder has the serious disadvantage of forcing the issuance of special kinds of preferred stock and thereby seriously complicating corporate structures. If stock dividends, payable in stock of the same kind, are used, it is legally questionable whether stockholders would be required to pay taxes on such distributions. However, even if legal, the compulsory issuance of stock of any kind would result in disturbance to corporate structures. The possibility of issuing stock is not always open to all corporations, as *e.g.*, public utilities, who have to secure permission from federal and state regulatory bodies. Moreover, there would be special difficulties for banks and insurance companies. The issuance of stock results in stock taxes and state franchise taxes which are foreign to

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holders if the company had, on the last day of the year of income paid the undistributed amount as a dividend to the shareholders who would have been entitled to receive it. . . ." The Australian Income Assessment Act, 1936–1938, Section 103.

[12] It is here assumed that steps are taken to preserve, in the dividends, the identity of special items of corporate income to the same extent as in the case of partnerships.

the income tax problem. Capital structures of corporations should not be controlled by tax avoidance considerations.

If information certificates of earnings were used, the economic repercussions upon the corporation would be no different from the use of the partnership method. No assets of the corporation would be depleted by the distribution. Of course the corporation might, as might also the partnership, be urged by its owners to adopt a more liberal cash distribution policy because of the pressure on them for tax funds.

There may be, of course, numerous obstacles obstructing the use of stock dividends or certificates (rather than cash dividends) for the purpose of carrying out a prompt and complete allocation of current corporate profits among shareholders. In this country ordinary stock dividends are not taxable as income under the decisions of the Supreme Court and, although the range of distributions of this general type that are construed to be taxable is steadily widening, legal obstacles still remain. Special problems of an economic or legal nature also arise in the case of corporations with deficits from previous years and in the case of other corporations where there may be other reasons which make it undesirable or impossible to capitalize fully and promptly all undistributable profits.

If the compulsory distribution method used is one which requires the distribution of all current corporate earnings in the form of cash dividends, the more remote economic consequences (as distinguished from the distribution of the tax burden) will be very different from those under the partnership method. There is some question as to whether the 1936 federal undistributed profits tax can fairly be described as falling within the compulsory distribution type because the penalties were not of a character that completely deprived corporations of the option to retain their earnings. However, it is certainly true that much of the complaint with that law could have been avoided had it in all cases been possible to avoid actual physical distributions of cash.[13]

The administrative difficulties involved in the use of the compulsory distribution method, however, are by no means so serious as those involved in the use of the inventory and partnership methods. Regarded merely from the viewpoint of taxation technique, much can be said in favor of it as a method of solving the problem now under consideration, particularly if stock dividends can be utilized. Its most serious faults, and to some of our members they seem grievous faults indeed, lie in the field of the economic consequences of compulsory cash distributions.

The Compensatory Tax Method

The three methods already discussed approach the problem primarily from the side of the individ-

[13] It is also true that without this cash distribution feature, the 1936 law would have had a less strong appeal to those who found merit in the view that the individual shareholders, rather than the corporate directors, should be the persons to decide how much of the corporate earnings should be saved and how such savings should be invested. Effects such as these, however, are not under consideration here. . . . At this point we are concerned with the problem of applying the personal income tax to corporate savings so as to achieve equity in the apportionment of the burden.

ual shareholder and attempt to secure a reflection in his accounts of his interest in the corporate profit. The fourth, and last, type of approach to be here described is distinctly different in that it has regard primarily for the corporation. In its purest form, it disregards the individual and imposes on the corporate profit a tax at a rate calculated to produce for the Treasury approximately the amount of personal income taxes the shareholders would have paid, had the profits been completely and promptly distributed.

This compensatory tax assumes many forms. In some cases it is coupled with a scheme for readjustment through credits and rebates to the shareholders, if and when the profits are distributed as dividends; in such cases the compensatory tax on the corporation takes on the character of a preliminary and tentative determination of individual tax liability, whose crudities are mitigated by the corrections ultimately available when the process of actual distribution of the profits takes place. In other cases little or no provision is made for future readjustments; dividends (when distributed) are exempt from further personal income tax and the compensatory tax stands or falls on the degree of precision with which, as originally assessed against the corporation, it achieves equivalence with the result which would have been reached had the corporate identity been completely disregarded.

How crude and approximate must be any compensatory tax on corporate profits which is not coupled with a scheme for correction and adjustment upon actual distribution will be readily appreciated after even a cursory examination of the character of the task which such a tax is called upon to perform. This task has already been briefly sketched in an earlier section. Aside from the possible desirability of preserving the identity of certain items of income which must be considered under all of the methods here discussed, it is necessary to find a rate which, when applied to the income of the corporation, will yield the Treasury approximately the same amount as the progressive personal income tax scale would yield if the corporate profits were distributed, promptly and completely, among the shareholders.

Let us suppose that such a rate were determined with technical precision at 25 per cent. How far removed are we still from a solution of the real problem! This rate applies to all corporate profits and, in the absence of subsequent credits or rebates, it imposes the same 25 per cent draft on each stockholder's share of the corporate profits,—on the share of the poor widow whose personal income tax rate is, say, 5 per cent, and on the share of the millionaire whose rate is, say, 75 per cent. Truly a compensatory rate which safeguards (even with the highest degree of precision) the aggregate yield to the Treasury, conceals in its rough average gross discriminations among individual shareholders.

It is, of course, in recognition of these discriminations that the various types of subsequent credits and rebates, so characteristic of most modern income tax statutes, are devised. A more or less crude compensatory rate is first applied to corporate profits as they are earned and then the problem is attacked in detail through adjustments in each in-

dividual return[14] when dividends are distributed.

At this point, however, a dilemma arises. If the compensatory rate originally imposed on the corporate profits is higher than the personal income tax rate of the poorest shareholder, it does him a hardship, for the government, in effect, takes and uses some of his money, beyond the amount it should take as tax, pending the future event (which may never transpire) of a dividend declaration giving rise to claim for rebate or credit. On the other hand, if the compensatory rate originally imposed on the corporate profits is lower than the personal income tax rate of the richest shareholder, it inevitably generates a tendency to postpone the distribution of profits, for by such a postponement the rich taxpayer can retain, for the period of deferment, the use of money which, theoretically, should be at the disposal of the public treasury.

The British impose a high rate on corporate profits (27½ per cent in 1938) and make refunds to individual shareholders whose personal income tax rate is lower than this figure when dividends are distributed; but even 27½ per cent is far below the effective personal income tax rates of the richest Englishmen, so that the incentive to postpone distributions is strong while the small taxpayers complain about the delay in securing their refunds. In fact, it is only through this complaint by the small taxpayers that pressure is placed on the British corporation to distribute its earnings,[15] and a very slight pressure it appears to be. In Belgium the corporation pays no tax on such portion of its profits as it may distribute and this may operate to stimulate a liberal dividend policy. Similarly, the Australian federal undistributed profits tax, in force from 1915 to 1922, was considered merely a prepayment of part of the individual shareholder's tax liability, elaborate care being taken to remove all penalty features by adjustments in the individual's tax.[16]

Traditionally our practice has been to impose a relatively low tax on corporate profits and to give a partial credit in the shareholder's personal income tax return when dividends are received. In the revenue act of 1936 this credit entirely disappeared. As compared with Great Britain, not only has our "compensatory rate" been low, but our individual surtax rates have been high. Under these conditions the temptation to postpone distribution of corporate earnings has been strong. The most ambitious effort to solve the problem of applying the personal income tax to corporate savings in a comprehensive fashion was the crude undistributed profits tax of 1936. Various efforts have been made to apply special treatment to those classes of corporations (personal holding companies) in which the temptation has been particularly strong and to corporations in general which "improperly" accumulate surplus.

[14] The adjustment may conceivably be made by the individual either directly with the Treasury or through the corporation.

[15] This statement does not take into account the fact that since 1922 (Finance Act of 1922, Section 21) the British statute has applied the partnership method (subjected to supertax) to the undistributed profits of closely held, non-public corporations which within a "reasonable" time have not distributed a "reasonable" part of their income.

[16] First Report of the Royal Commission on Taxation, Commonwealth of Australia, 1932–33, p. 9 *et seq.*

Within the range of the four general types of solution outlined above a specific formula for applying the personal income tax to corporate savings must be selected, but before addressing ourselves to this task, we desire to make certain observations about the efforts of the federal government to penalize corporations that accumulate surplus with the purpose of avoiding surtaxes.

Federal Efforts to Tax "Improper Accumulations"

Since 1921 the revenue acts have taxed, at penalty rates, accumulations of corporate savings where the failure to distribute has been the result of the purpose to save surtaxes to the stockholders.[17] Because of the difficulty of proving motive, no real effort was made for many years to enforce this penalty tax. Now, with the elimination in the Revenue Act of 1939 of the last vestige of the undistributed profits tax, much more strenuous efforts are being directed to its enforcement. The proponents of this method urge that it makes unnecessary any other tax on undistributed profits.

Undoubtedly, more strict enforcement of this high penalty tax on "improper accumulations" will cause some corporations, that would otherwise have accumulated profits, to distribute them. Moreover, some corporations that do accumulate profits in the face of the penalty will be caught by this provision and will pay penalty taxes. However, the device at best solves only a small part of the problem, and that at the expense of fairness and sound tax administration.

[17] Sec. 220 of the 1921 Revenue Act. Under the 1918 Revenue Act (Sec. 220) such corporations were taxed as partnerships.

Under the four types of solution discussed above, all corporate savings are taxed either to the individual shareholders, as though distributed, or they are taxed to the corporation at rates designed to produce a total yield equal to the amount which would have been collected had all the savings been in the hands of individuals. The theory behind all four of these types of solution is that, insofar as possible, corporate savings should not be subsidized, from a tax standpoint, as compared with other savings. The theory underlying no one of them implies the assumption that corporate savings are evil or that the corporation or the stockholders are committing any wrong in failing to distribute profits. The theory is simply that there is no reason for favoring corporate savings as compared with savings effected by individuals, and that if distributions are withheld for reasons which may be perfectly sound and proper, the savings which are thus withheld should nevertheless be subject to the same taxes to which such savings would be subject in the hands of an individual or partnership. As between similarly situated corporations, the total earnings of one corporation do not bear higher taxes than the earnings of another corporation merely because the first corporation chooses to distribute its earnings and the other corporation, for reasons of its own or of its stockholders, chooses to accumulate them.

Under the provisions of the law segregating and penalizing "improper" accumulations, taxation depends not upon what the corporation does, but upon the purpose which motivates its action. Corporations identically situated may be taxed at entirely different rates. Cor-

porations A and B may be in the same business and have identical set-ups. Suppose each of the companies earns $100,000 and distributes none of it. Assume that the same amount of surtax is saved to the stockholders of each, but that corporation A can show that it was attempting to build up a million dollar fund to expand its plant, presumably because the stockholders felt that they would be benefited by such expansion, while corporation B, on the other hand, admits that its motive in withholding the money was to save taxes to its stockholders. A would be free from, while B would be subject to, a heavy penalty tax.

Generally speaking, under the tax laws, motive is unimportant. Fortunately external facts and not the motives in the minds of taxpayers are usually the determining factors. Motive is difficult of proof in nearly all cases, and, in addition, it is the type of question which breeds more friction and ill-feeling than almost any question of external fact. The chances for manipulation are manifold. Finally, the introduction of this device, based on motive, still leaves in a favorable tax position the larger part of the savings which business in the corporate form accumulates for business use, as compared with savings accumulated for the same purpose by unincorporated concerns.

Space does not permit inclusion of the Committee's recommendations. All members agreed that considerations of equity call for as heavy a tax on undistributed as on distributed profits. However, they differed in their estimates of the legal and administrative practicability of the alternative proposals, and also on the importance of stimulating or discouraging corporate savings. The majority of the Committee preferred tax devices which would affect the actual cash dispositions of corporations as little as possible. The following devices were suggested:

(1) Tax by the partnership method corporations whose capital structure is simple and whose stocks are not widely dispersed. If this method is not legally valid, a constitutional amendment should be sought.

(2) For all other corporations, the majority preferred a method which would approximate the results of the partnership method. The members of the majority could not agree on a choice and presented several alternatives; namely, the use of information certificates, the use of taxable stock dividends, and the application of a compensatory tax.

CARL SHOUP

The Concept of Excess Profits under the Revenue Acts of 1940–1942

THE excess profits tax in the United States has been employed mainly as a war measure. Because of the likelihood of its readoption as such and because of a considerable following for its application during peacetime, the tax is of more than historical interest. Some of the technical difficulties in applying the tax during World War II are explained in the following paragraphs from an article by Carl Shoup: *

Congress has developed a concept of excess profits during the past three years, vague on some points but fairly definite on others. It is not expressed in summary form anywhere in the four revenue laws that have initiated and revised the excess profits tax; the present paper is an attempt to distill it out and compare it with concepts designed for peacetime taxation.[1]

Implicit Distinction Between War Profits and Other Profits.

Although the tax law makes no formal distinction between profits due to the war and all other profits, it is evidently intended to reach only the former. The taxpayer is given the option to use either the base-period method or the invested-capital method, whichever results in the smaller tax.[2] As a consequence, the tax is not imposed on profits on the grounds that they are larger than they need to be to induce the firm to carry on at its existing level of output. If excessive profits in this sense were being received in the base period, they can be received in wartime free of the excess profits tax. Further evidence of the desire to tax only prof-

[1] To facilitate this comparison, the order in which the topics are treated follows in general that employed in the author's "The Taxation of Excess Profits," *Political Science Quarterly,* LV (1940), 535; LVI (1941), 84, 226.

[2] An advance tabulation of data from taxable excess profits tax returns for 1941 (*i.e.,* with all or the greater part of the accounting period falling in 1941) received in the Bureau of Internal Revenue from the offices of the collectors through July 31, 1942, unaudited, show that the two methods were about equally popular in terms of number of returns (18,760 used the base-period method and 18,337 the invested-capital method); but the aggregate excess profits net income of the taxpayers using the base-period method was $7.0 billion, against only $3.4 billion of those using the invested-capital method. Treasury Department Bulletin, Sept. 1942, p. 71.

* Reprinted by permission from *Law and Contemporary Problems,* Vol. X (Duke University School of Law, Durham, N.C., Winter, 1943), pp. 28–42.

its that are due to the war lies in the refinement of the base-period concept, discussed below, to approximate the peacetime earning power inherent in the corporation as it stood just before the defense effort of the United States got well under way.

Moreover, even an increase in profits over the level of the base period is exempt if that level was very low in terms of per cent of invested capital. Specifically, the taxpayer's option referred to above means that the law exempts any increase in profits over those of the base period up to the point where the wartime earnings are 5% (ranging up to 8% for smaller firms) of invested capital. This provision might reflect a belief that, even had the United States not become involved in the war, the corporations in question might have improved to the point of earning at least 5% (to 8%) in 1940 and the following years. But a simpler and probably more nearly accurate explanation is that Congress desired to give the depressed industries of the 'thirties, like steel and the railroads, a chance to make a certain minimum amount of profit out of the war, the minimum reflecting something more than was needed to keep them going during the war but perhaps something less than would be required over the very long run in peacetime.

The law makes no attempt to impose a higher tax rate on income from government contracts. Under the present tax, which varies from 72% to 81% after post-war refund, there is not much room for an added rate on such income. Renegotiation of contracts is perhaps considered to provide the extra safeguard needed, although in practice it may work the other way around, with renegotiators finding their task made bearable only by the thought that the Government will in almost any case get 72% to 81% of what is not renegotiated out. Perhaps the pattern of the last war will be followed, and any reduction in tax rate in the immediate post-war period be disallowed with respect to income from wartime government contracts.

Emphasis on Experience of the Particular Corporation

The attempt to restrict the excess profits tax to war profits involves treating each taxpayer in the light of its own particular business history and prospects. The invested-capital method does not lend itself readily to this approach; the base-period method does. Congress has shown its preference for the individual-case approach by refining the base-period method and enlarging its scope in successive revenue acts. Indeed, the process of refinement has come close to creating a third, overriding measure for excessive profits, one calling for more individual treatment than even the test of actual experience. This third concept is difficult to define briefly, but it seems to be something like this: excessive profits are those in excess, not of the profit that the firm did earn in the base period, but of the profits that it could have earned in the base period if all through that period there had been fully operative the reasonably assured potentialities that the concern exhibited at the close of the last year of its base period and if the base-period years had been marred by no exceptional or unrepresentative physical or economic misfortunes. Or, as the Senate Finance Committee put it briefly, the excess profits

credit based on income will be "predicated upon an amount which is a fair and just reflection of the normal earning capacity of the business."[3]

The 1940 law, with some exceptions, used the actual base-period experience of the taxpayer as a direct measure of what should be a tax-free return in the war years. But under the 1942 law, the actual base-period experience will in many cases be not so much a measure as a preliminary indicator, a starting point from which to build up a hypothetical statement of what might have happened to the particular corporation in question under fairly happy business conditions. Most of this building-up takes place under the auspices of Section 722 of the Internal Revenue Code, which was radically expanded by the 1942 act. The extent to which Congress is willing to have each case considered separately is indicated by the following illustrations, selected from the report of the Senate Finance Committee and the Treasury Regulations, in which an "excessive and discriminatory" tax could be avoided by a "constructive average base period income" that would be "a fair and just amount representing normal earnings":

* * * *

The Invested-Capital Method

The invested-capital method plays a dual role in the excess profits tax law: in some cases it supplements, and in others it replaces the base-period method.

As time passes and a concern expands or partially liquidates, its base-period experience, even when refined and reconstructed with the exercise of the most powerful imagination and ingenuity, becomes less satisfactory. Hence the provision allowing the addition, to the average base-period net income, of 8% of the net additions to capital since the end of the base period, and requiring the subtraction of 6% of the net capital reduction. Expanding concerns will thus, in time, be restricted to a return approaching 8% on their total invested capital, although they may have had base period earnings at a much higher rate on the amount of capital then invested. And shrinking firms will be allowed higher and higher percentage returns on what is left of their capital—a privilege that will probably be immaterial, or the concern would not be shrinking. But this section of the law (Sec. 713 (g)), although carefully worked out as far as it goes, does not allow the inclusion of borrowed capital, and provides only a flat rate of return; it therefore gives the impression that it is not expected to play a very important role.

As an alternative to the base-period method, the invested-capital method requires an estimate of the total amount of invested capital as of a certain date. The present law follows the (United States) precedent of the First World War in avoiding a current valuation of the assets actually in use in the business, and measuring instead the money and other property paid in to the corporation, plus earnings and profits accumulated subsequently. With some exceptions, appreciation in the value of assets—due, for instance, to the development of a quasi-monopoly position—is therefore not counted as a part of invested capital so long as it is unrealized and hence has not

[3] *The Revenue Bill of 1942*, Sen. Rep. No. 1631, 77th Cong., 2d Sess. (1942) 197.

appeared in earnings and profits. The consequent impairment of vested property rights implicit in this refusal to take unrealized appreciation into account has been avoided by making the use of the invested capital method optional with the corporation, which can therefore rely on a rich base-period experience to free it from excess profits tax. The current profit may be 20%, or 100%, or any other per cent, of invested capital, without becoming subject to the excess profits tax, so long as it does not exceed the rate of return implicit in the actual or constructive base-period figure (and assuming no appreciable net addition to capital since 1939). Congress strenuously resisted the Treasury's efforts to turn the option in favor of the Government, as under the 1918 law. Evidently the protection of the current value of corporate shares was considered by Congress to be very important.

Giving the option to the taxpayer also protects corporations whose base-period experience has been so poor that no amount of "reconstruction" can get them a credit equal to more than a very low return on paid-in capital, surplus, and accumulated earnings and profits.

From the technical point of view, the chief features of interest in the present law's concept of invested capital are: (1) the tracing of the corporation's history back through tax-free reorganizations; (2) the use of basis (unadjusted) where property was paid in for stock, thus avoiding, with some exceptions, a new, direct valuation of the property as of that time, in cases where the value of the stock itself was not readily ascertainable; (3) the use of basis (adjusted) for determining the ratio of inadmissible assets to total assets; (4) the inclusion of part of borrowed capital; and (5) the refusal to limit the inclusion of intangibles. The first three will not be discussed here, since they do not represent a fundamental change in concept, although the use of basis is an important technical step in avoiding troublesome valuations.

Not even a summary of the issues involved in borrowed capital can be attempted here. But it may be observed that the present law gives them only a partial test.

In the first place, the law includes in invested capital only one half the borrowed capital, after excluding entirely all borrowings not evidenced by certain formal written instruments. This fraction represents a compromise between (1) the fear of hardship that exclusion of borrowed capital would cause, especially to young, growing corporations that must borrow heavily to take advantage of opportunities before they vanish, and (2) the fear that unlimited inclusion of borrowed capital would be abused by unnecessary borrowing on the part of strong corporations that could get loans at rates of interest so low that there would be a gain from the transaction even if the borrower could find no use at all for the money. It is virtually certain, however, that if the same amount of time had been devoted to strengthening the invested-capital concept as has been devoted to the base-period measure, a way would have been found to obviate such abuse, while retaining the advantages desired, and thus permitting the full inclusion of borrowed capital.

In the second place, the rate of return allowed on invested capital

is set so low (5% to 8%) that in a few instances it is probably exceeded by the interest rate at which the taxpayer is borrowing. In these cases, the taxpayer would be better off if borrowed capital were excluded entirely and he were consequently allowed a full deduction, in computing excess profits net income, of interest paid, instead of being restricted to deducting half of the interest as at present.

The existing law makes no attempt to pioneer by including leased capital in invested capital. Instead—evidence again of the strong preference for the base-period approach—it apparently allows for the construction of an imaginary base-period income, for corporations not in existence before January 1, 1940, as shown by this illustration: ". . . a corporation . . . commenced business in 1941 with a leased plant valued at $1,000,000, but with invested capital paid in of only $40,000. Since the invested capital of such company is unusually low relative to the size of its operations, it would be subject to an unreasonable tax burden if required to compute its excess profits tax under the invested capital method. It would therefore be given constructive average base period net income and would be entitled to compute its credit on the average earnings method." [4]

The legitimacy of an intangible asset as a component of invested capital is fully recognized, in contrast to the excess profits tax law of the last war. And here again the predominance of the base-period approach is apparent. When the intangible has failed to get on to the taxpayer's books (technically, when it has no tax basis), as when it has arisen from outlays that have been charged off to expense, the inaccuracy is corrected, not necessarily by a revamping of the expense and capital accounts, but by building up a hypothetical (constructive) base period income:

> For example, a corporation, which was of a class requiring little invested capital but necessitating the establishment of contacts with the trade which it was its business to supply, commenced business early in 1940. It lost money during its first 2 years of operations but by 1942 began to realize sizable profits. This company would be eligible to receive a constructive average base period net income on the grounds that one of its principal assets, the goodwill of its clientele, was not reflected in invested capital.[5]

Among the disadvantages of computing invested capital through the liabilities side of the balance sheet, instead of segregating out the assets actively used in the business and valuing them currently, there are several important ones that the present law does not remove. This is understandable so long as the invested-capital method is regarded as a sort of general relief provision for a short-lived tax based primarily on the income-credit method, for these disadvantages will probably not be serious during another two or three years of war.

One of them is the inducement offered to arrange a transfer of corporate ownership of the assets of a prosperous business with an earning power well above the tax-free return allowed on the corporation's invested-capital figure. If the sale of the assets, from one corporation to another, can be so arranged that it

[4] Sen. Rep. No. 1631, *supra* note 3, at 203–204.

[5] *Id.* at 203.

does not fall into the "tax-free" category, and if the hitherto unrealized appreciation in value of the assets, now realized by the sale, can be made to appear in the form of gains on "capital assets," the year's ordinary corporation tax is increased, but the excess profits tax is decreased for the current year and all future years: the net long-term capital gain realized upon the sale of the assets (in excess of the year's net short-term capital loss) is taxable under the ordinary corporate income tax at a maximum rate of 25%; but a new, high invested capital figure is created that will serve to exempt much or all of future income from the excess profits tax. So long as the tax is believed to be temporary, however, there is probably little danger of such tax-induced sales.

Conversely, if a corporation has sustained an unrealized loss in the value of its assets, any transfer of the assets, not under a "tax-free" exchange, will cause the loss to be realized and will in general make the assets worth less for excess profits tax purposes. Indeed, a similar deterrent to transfer exists even when the loss in value of assets has been realized, that is, has been reflected by the accumulation of a deficit in the earnings and profits account. The law does not require that such a deficit be deducted from the original capital and surplus paid in, in computing invested capital. But, with some exceptions, as soon as the assets are transferred to another corporation, whether or not under a "tax-free" exchange, the accumulated deficit becomes realized, in fact or in effect, in the computation of the invested capital of the transferee corporation. A corporation with assets having a present worth and an adjusted basis of $10 million, and outstanding stock of $25 million and an accumulated deficit of $15 million, can reckon its invested capital at $25 million; exceptions aside, if the assets are transferred to another corporation, old or new, they give rise to only $10 million of invested capital. There has been some evidence that the benefit accruing from holding on to a book deficit has impeded important reorganizations.

The present law does a little cautious pioneering in allowing for differences in risk. It does not explicitly refer to such differences, but they were the chief consideration in the enactment of the borrowed capital provision (a given amount of total investment is much more of a gamble at great odds by the equity owners if a large part of the investment is borrowed capital) and in the graduation of the permitted rate of return on investment, which now varies from 8% on the first $5 million of invested capital to 5% on the excess over $200 million. Graduation of this kind is a recognition of the tendency of risks to cancel out in large numbers; a small company drilling one oil well a year, for example, obviously faces more risk than a large one drilling many hundred. Mere size, other things being equal, itself lessens risk.

The Scope of the Tax

The present law seems to reflect a desire to tax primarily, or even exclusively, excess profits derived from the employment of business capital in the corporate form. But the exclusion of profits derived chiefly from personal service reflects more a deliberate aim, a freely chosen limitation on the concept, than does the exclusion of all unincorporated en-

terprises, which was dictated by fear of administrative difficulties. If Congress could have been shown some easy way of isolating excess profits on capital employed in unincorporated enterprises, it would very likely not have restricted the tax to corporations. At least, it may be presumed that Congress did not aim at promoting disincorporation, which appears to have reached significant proportions in some industries, owing to the excess profits tax and the corporation tax. (The writer has the impression that this is the case with the women's garment manufacturing industry, for example). The exclusion of profits derived primarily from personal service, on the other hand, seems less forced by circumstances than by doubt over the soundness of a concept of "excess" personal-service income. Still, if that were so, why did not Congress grant outright exemption to those corporations "of a class in which capital is not an important income-producing factor" (Sec. 722 (c) (2)), like a corporation doing business as fashion consultants, employing a large technical and professional staff? Incidentally, in these cases, it becomes imperative to resort to a constructive base period income, if the corporation was not in existence before January 1, 1940. Both intent and execution remain somewhat unclear in this personal-service area of the "excess" concept.

Elimination of the One-Year Accounting Period

"Elimination" is too strong a word to apply literally with respect to what has happened to the one-year accounting period under the income tax and the excess profits tax, but it is scarcely too strong if taken in the sense of end results over a period of years. In recent revenue acts, breaches have occurred at widely separated points in the barriers, necessarily somewhat artificial, that mark one year's income off from the next. The speed with which last-in first-out inventory accounting has gained favor for tax purposes is an illustration; the revival of the two-year carry-forward ("carry-over") of losses in the Revenue Act of 1939 is another. But it remained for the Revenue Act of 1942 to effect what will probably turn out to have been the most important change of this kind in any federal revenue law, by adding a two-year carry-back to the two-year carry-forward and making it applicable not only to operating losses but also to unused excess profits tax credits. In effect, something approaching a five-year moving average has been introduced. There are probably better averaging methods available, but proponents of averaging will not be inclined to complain, in view of the size of this one step—if it really is a firm step. To mean much, the carry-back provision must be kept in force, even though the rest of the excess-profits tax is repealed, for some time after the war; and Congress and the public must be ready to accept the necessity of substantial refunds to corporations, including very large ones that will not be in financial distress, however good their claim may be on grounds of equity.

The net income derived from gross income of any given class, for the taxable year, may be decreased, for excess profits tax purposes, to the extent that it is "abnormal" either in nature or amount and can also be shown to be attributable to other years. Abnormality in amount is defined as being more than 25% higher

than the average for the four previous taxable years. Consequently, any class of gross income that has been increasing for four years at an annual rate (compounded) of more than about 10% is "abnormal." But the Regulations make it clear that fluctuations due merely to changes in prices, costs, demand or competition do not make the abnormal income attributable to other years.

The net abnormal income gives rise to excess profits tax for the past or future years to which it is found attributable, except that if it falls in 1939 or an earlier year it has no effect at all, not even in the measurement of base-period income. Net abnormal income thrown into a future year cannot give rise to an added tax in such a year greater than the tax saved in the present year (minus the increase caused by this provision in intervening years). Hence the taxpayer cannot lose, by this averaging provision, no matter what happens to tax rates.

There may still be a practical problem of tax payment if the taxpayer is not provident. When the future year arrives, he will have to pay perhaps 90% of a substantial amount that he received, not in that year, but some years before. It will be interesting to observe whether this difficulty, considered by some to be a decisive objection to the moving-average type of income-averaging, proves important in practice. Surprisingly enough, the data for the 32,976 returns filed for 1941 (to July 31, 1942) indicate very little use of this relief for "abnormalities" of the taxable year: "The number of returns with abnormal income attributable to other years is 528." [6] In any event, the construction of and experience with this elaborate averaging device may easily have significant implications for post-war income tax legislation despite its intended inapplicability to profit fluctuations associated with the business cycle.

Income Tax and Excess Profits Tax

The extraordinary increase in the yield of the excess profits tax on 1941 and subsequent incomes over that on 1940 incomes [7] is due in large part to the fact that in 1940 the normal tax and surtax were computed first, and deducted from net income in computing the base of the excess profits tax, while in 1941 the excess profits tax (in 1942, the excess profits credit) was computed first and the normal tax and surtax were then applied only to the remainder. The change was motivated chiefly by a desire for the increased revenues it would bring, under a given set of rates, and did not reflect any fundamental change of mind concerning the proper concept, aside from the consideration advanced by the Ways and Means Committee that "It seems unfair to allow that part of the income tax which is computed on income which is not subject to the excess profits tax to reduce the excess-profits net income." [8] But the 1940 method itself did not reflect any profound convictions on concept. If the normal tax and surtax are assumed to be

[6] Treasury Department Bulletin, Sept. 1942, p. 71. The returns "filed for 1941" here include only those for fiscal and part years beginning in, and the greater part of whose accounting period fell in, 1941.

[7] Fiscal 1941: $164 million; fiscal 1942, $1.6 billion; fiscal 1943, estimated, $5.7 billion; fiscal 1944, estimated, $10.3 billion. *Budget . . . for . . . Fiscal . . . 1943*, p. A-3; *Budget . . . for . . . Fiscal 1944*, p. A-1.

[8] *The Revenue Bill of 1941*, H. R. Rep. No. 1040, 77th Cong., 2d Sess. (1941) 24.

non-shiftable and are designed to give the Government a stated share in the corporation's standard, fair, or peacetime reward, the present system is logical. Moreover, as the excess profits tax rate approaches 100%, the 1940 system blurs the distinction between excess profits tax and normal and surtaxes; with a 100% excess profits tax rate and the normal and surtaxes deducted in computing the excess profits base, a decrease in the normal and surtaxes would bring the taxpayer no gain and an increase, no burden. Under the present system, a variation in the normal or surtax rates has a real meaning for the corporation, regardless of the excess profits tax rate. But, assuming a given set of normal tax, surtax, and excess profits tax rates, the present system leaves the corporation with large excess profits better off than the corporation with small excess profits, compared with their relative situation under the 1940 law. Under that law, as total profits increased (once the corporation had already passed into the excess profits zone), the normal tax and surtax took part of the increase and the excess profits tax took part of the rest of the increase. Now, the only thing that happens is that the excess profits tax takes part of the increase. In other words, under a given set of rates, the present system imposes a lower combined marginal rate (even disregarding the 80% limitation).

The change in 1941 tended to make the base-period alternative less attractive, since base-period income taxes were imposed at lower rates than the wartime normal tax and surtax, but there is no indication that the change was made deliberately to increase the relative importance of the invested-capital method.

Summary

The concept of excess profits in the present law, partly explicit and partly implicit, seems to be something like this: excess profits are the excess of the average annual profits of a business corporation during the years 1940–19— over 89% of the annual average profits that would have been realized in the three best years of the period 1936–1939 (or 95% of the four-year average) by the corporation in question if its reasonably assured potentialities, as of January 1, 1940, had been allowed full expression during that time, free of rarely occurring unfortunate episodes, physical or economic, and if the general business background had been happy enough to permit a return of at least 5% to 8% on the capital put into the business, including half the borrowed capital.

This definition, long and awkward though it is, obviously slurs over or omits considerations that would be important if the tax were to have a long life ahead of it. But there seems to be little tendency anywhere to assume that it will. For one thing, as the analysis above has indicated, the workmanship that has been lavished on the law and regulations has been concentrated on the features that are more significant for a temporary tax that carries a very high rate. And this kind of effort, requiring as it does a continual straining to provide for a hundred and one special cases where the tax rate might otherwise prove destructive, has been so exhausting to the research staffs, the bill drafters, the Congressional committees, and the taxpayers and their representatives that the repeal of the excess profits tax could, on the whole, bring

as its immediate reaction only a sense of relief. Under a much lower rate, with effort devoted to refining the standards that would be applicable over a long period of time, an excess profits tax might conceivably become a permanent part of the federal revenue system. But this is not the kind of tax that Congress wanted for war, and there is as yet no indication that Congress wants it for peace.

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THE EXECUTIVE COUNCIL OF THE AMERICAN FEDERATION OF LABOR

Income Tax Exemptions

A VITAL point of personal-income-tax policy concerns the "breadth of the base." This is largely a matter of the amount of exemption for living expenses allowed the taxpayer and his dependents. The following is a news story by Joseph A. Loftus in the *New York Times* relating the action of the American Federation of Labor Council concerning postwar income-tax exemptions: *

The executive council of the American Federation of Labor called today for prompt Congressional action on tax reductions, and said that the cost of government also must be reduced. The council declared that the Treasury's tax plan was preferable to the program approved by the House, but believed both were faulty.

* * * *

The AFL council said also that it strongly opposed any attempt to reduce the so-called luxury taxes at this time.

"From labor's point of view both plans are faulty because they fail to deal with the important problem of increasing personal exemptions," the executive group said.

"The average American citizen is now required to pay taxes on an income base which is far above his actual net income. The personal exemptions were reduced in wartime to a point that did not attempt to reflect the inescapable cost of maintaining a home and a family. Congress would never think of forcing corporations to pay taxes on gross incomes, before operating costs were deducted, but it has imposed that

* Oct. 17, 1945, p. 14, col. 2; editorial, p. 18, col. 1. Reprinted by permission of the *New York Times*.

intolerable condition on the great masses of the American people in the low-income groups who can least afford to carry the extra burden."

The Council continued that it would press for restoration of exemptions to the pre-war level of $2,000 for a married person or head of a family, $1,000 for single persons, and $500 for each dependent.

The *New York Times,* in the same issue, comments editorially on income-tax exemptions as follows:

* * * *

We may grant that the total amount of revenue collected from the 5,000,000 to 12,000,000 taxpayers that would be dropped from the rolls under the various plans before the Senate is comparatively small. But the political importance of keeping those taxpayers on the rolls, particularly at a time when the budget is still very heavily out of balance, is a different matter. For we are unlikely to get a healthy fiscal policy in a democracy if the false impression prevails that no matter how much the Government spends the whole tax burden, or the major share of it, can be thrown upon a politically negligible minority of the voters. Such a belief is simply untrue. Excessive taxes at any point of the economy lead to unemployment and economic disruption that fall on everybody. Excessive expenditures are eventually paid for, under an unbalanced budget, in an inflation that falls with equal force upon poor and rich alike. Inflation is the equivalent of a flat income tax on everybody, without exemptions. It is also the equivalent of a flat capital levy on savings accounts and insurance policies, without exemptions.

That is why it is so important to have as wide an income tax as possible. It makes no difference whether the amount collected from those in the lower income brackets is a nominal sum. What is important is that the great majority of voters be kept aware at all times that they are making a contribution toward every dollar that the Federal Government spends. For that in fact is what everyone is certain to do in the long run. A small visible tax now will save the lower income groups from a much larger "invisible" but none the less real tax tomorrow.

FRANKLIN D. ROOSEVELT

Income Tax Evasion and Avoidance, 1937

ALTHOUGH the net income tax is generally regarded as one of the fairest, if not the fairest tax in the tax system, it is also one of the easiest to evade. In 1937, the President called to the attention of Congress some of the "loopholes" in the law as it was then. Some of these loopholes have been stopped but others remain. The President said: *

To the Congress of the United States:

A condition has been developing during the past few months so serious to the Nation that the Congress and the people are entitled to information about it.

The Secretary of the Treasury has given me a report of a preliminary study of income-tax returns for the calendar year 1936. This report reveals efforts at avoidance and evasion of tax liability so widespread and so amazing both in their boldness and their ingenuity that further action without delay seems imperative.

We face a challenge to the power of the Government to collect, uniformly, fairly, and without discrimination, taxes based on statutes adopted by the Congress.

Mr. Justice Holmes said, "Taxes are what we pay for civilized society." Too many individuals, however, want the civilization at a discount.

Methods of escape or intended escape from tax liability are many. Some are instances of avoidance which appear to have the color of legality; others are on the borderline of legality; others are plainly contrary even to the letter of the law.

All are alike in that they are definitely contrary to the spirit of the law. All are alike in that they represent a determined effort on the part of those who use them to dodge the payment of taxes which Congress based on ability to pay. All are alike in that failure to pay results in shifting the tax load to the shoulders of others less able to pay, and in mulcting the Treasury of the Government's just due.

I commend to your attention the following letter from the Secretary of the Treasury:

THE SECRETARY OF THE TREASURY,
Washington, May 29, 1937.

THE PRESIDENT,
The White House.

"My Dear Mr. President: As you know, the Treasury was surprised and disturbed by the failure of the

* *Hearings before the Joint Committee on Tax Evasion and Avoidance*, 75th Cong., 1st Sess. (1937), pp. 2–7.

receipts from the income tax on March 15 to measure up to the Budget estimates. Therefore, we undertook an immediate investigation. Only a preliminary report can be made at this time, because the complete investigation covering all the income-tax returns filed will require the balance of this year. Furthermore, since many of the returns of large manufacturing corporations have not yet been filed, the present report is confined almost wholly to data disclosed by the individual tax returns.

"But even this preliminary report discloses conditions so serious that immediate action is called for. More than the usual examination and audit by the Treasury is needed. It seems clear that if tax evasion and tax avoidance can be promptly stopped through legislation and regulations resulting from a special investigation a very large portion of the deficiency in revenues will be restored to the Treasury.

"I herewith enumerate some of the principal devices now being employed by taxpayers with large incomes for the purpose of defeating the income taxes which would normally be payable by them. As we continue our preliminary examination other devices are being disclosed.

1. *The Device of Evading Taxes by Setting up Foreign Personal Holding Corporations in the Bahamas, Panama, Newfoundland, and other Places Where Taxes Are Low and Corporation Laws Lax*

"Americans have formed 64 such companies in the Bahamas alone in 1935 and 1936, and 22 more were organized by Americans in the Bahamas during the past 2 months. Panama and Newfoundland seem to be even more fertile territory, since their corporation laws make it more difficult to ascertain who the actual stockholders are. Moreover, the stockholders have resorted to all manner of devices to prevent the acquisition of information regarding their companies. The companies are frequently organized through foreign lawyers, with dummy incorporators and dummy directors, so that the names of the real parties in interest do not appear.

"One American citizen with a $3,000,000 Bahamas corporation has apparently attempted to prevent the Bureau of Internal Revenue from catching up with him by filing his individual tax returns in successive years from towns in New Brunswick, British Columbia, and Jamaica.

"Another individual believes that he has been so successful in removing his assets from the United States to the Bahamas that he is defying the Treasury to collect a tax upon a $250,000 fee he has received; and by way of insult, he has offered to compromise his admitted tax liability of $33,000 for past years by a payment of $1,700.

"Still another individual showed a large net loss on his personal return for 1936. In considerable part the loss was due to the large deduction he claims for interest on a loan made to him by his personal holding company. But the man in question is no object of charity, for his personal holding company, organized in Canada, had an income of over $1,500,000 from American dividends in 1936, though it has not yet filed a return.

"Perhaps the most flagrant case of this character is that of a retired

American Army officer with a large income from valuable American securities which he desires to sell at a very large profit. To escape our income- and inheritance-tax laws, he used the device of becoming a naturalized Canadian citizen, and 6 days later organized four Bahamas corporations to hold his securities. He and his lawyers apparently think that he can now sell his securities free from any taxes on his profits, since there are no income taxes in the Bahamas, and that he has adroitly escaped American taxes.

2. *The Device of Foreign Insurance Companies*

"Two New York insurance agents have caused the organization of insurance companies in the Bahamas with a view to enabling taxpayers to secure spurious deductions for interest through an ingenious scheme for the issuance of life-insurance policies. Americans who went into the scheme purported to pay a large single premium for their policies, but immediately borrowed back practically the entire sum. Under the plan the so-called policyholders sought to obtain a large deduction for interest on this loan, although the fact was that no interest was really paid. By this means five prominent Americans sought to evade nearly $550,000 in income taxes in the years 1932 to 1936. This fraud was discovered by the Treasury's investigators and all of the taxpayers have now submitted offers to pay the full amount of taxes evaded, plus interest. Until our investigation is completed we do not know how many similar companies may have been organized in other countries, and utilized by our citizens; nor do we yet know whether this newly invented type of fraud has other ramifications.

3. *The Device of Domestic Personal Holding Companies*

"The rates of tax applicable to personal holding companies were reduced in 1936 at the time of the enactment of the undistributive profits tax. It was believed at that time that the combined rates of the two taxes would be sufficient to insure the distribution of the entire incomes of these companies, and the consequent imposition of surtaxes upon their owners. This expectation has not been realized.

"Thus, the single stockholder of one large personal holding company saved himself $322,000 by causing his company to distribute none of its income to him.

"In another case, a man and his wife saved $791,000 through the use of personal holding companies in 1936.

"In a third case, the personal holding company reported over $500,000 of net income but the total taxes paid by the two stockholders, husband and wife, were less than $60,000, due principally to credits for payments on indebtedness the holding company prudently incurred in accumulating properties for its owners. If the personal holding company had not been in existence, the stockholders would have paid over $200,000 additional income taxes.

"Another favorite device is to organize a considerable number of personal holding companies, not only for the sake of reducing the tax, but of increasing the Treasury's difficulties in auditing transactions between companies. At last accounts one man had caused to be set up some 96 companies scattered all over the country.

Two other individuals were utilizing 23 personal holding companies.

4. The Device of Incorporating Yachts and Country Estates

"Many wealthy taxpayers today are dodging the express provisions of the law denying deductions for personal expenses by incorporating their yachts or their country estates, turning over to the yacht or to the estate securities yielding an income just sufficient to pay the entire expenses of operation. Hundreds of thousands of dollars in income taxes are annually avoided in this way.

"Thus, one man's yacht is owned by his personal holding company, along with $3,000,000 in securities. He rents the yacht from his company for a sum far less than the cost of upkeep, and the company uses its income from the securities to pay the wages of the captain and crew, the expenses of operating the yacht, and an annual depreciation allowance. None of these items would be deductible if this individual owned the yacht personally.

"A great many wealthy taxpayers are utilizing a similar arrangement for the operation of their country places and town houses.

"One man has placed his $5,000,000 city residence in such a corporation, another his racing stable whose losses last year were nearly $200,000. The tax savings he thus sought to obtain through the use of the holding company were $140,000.

"One wealthy woman has improved on the general plan of evasion by causing her personal holding company, which owns her country place, to employ her husband at a salary to manage it. She can thereby supply him with pocket money, and in effect claims a tax deduction for the expense of maintaining him.

5. The Device of Artificial Deductions for Interest, Losses, etc.

"Taxpayers are seeking greatly to reduce their personal income taxes by claiming deductions for interest on loans to them by their personal holding companies, or on loans to them by their family trusts. These transactions normally have no business purpose, but are merely an artificial means of shifting income from one member of the family subject to high surtax rates to another member of the family subject to lower rates.

"Thus, one woman claims a large annual deduction for interest on a loan made to her by her husband as trustee of a trust which she created for their children. The mother thereby seeks to secure a deduction for her contribution to the children's support, and since the trust is revocable by her husband, the parents still have the desired control over the property and its income.

"In the same category are losses deducted by taxpayers who claim that their racing stables or hobby farms were operated for profit, even though a profit is never realized. Thus, a prominent manufacturer seeks a deduction of over $125,000 against his income from his business, on account of his losses in operating a chicken farm.

6. The Device of the Creation of Multiple Trusts for Relatives and Dependents

"Splitting income two ways, between husband and wife, reduces income taxes and leaves the family income intact. Splitting the family

income many ways by means of many trusts, all for the same beneficiaries, may effect a much greater saving, while leaving the money actually in the same hands. For the creator of the trust often constitutes himself or his wife as trustee, and thus retains full control over the investment and disposition of the fund itself and of its income.

"One thrifty taxpayer has formed 64 trusts for the benefit of four members of his immediate family, and thereby claims to have saved them over $485,000 in 1 year in taxes.

"Another thrifty pair have constituted 40 trusts for their relatives, and a prominent lawyer and his wife utilize 16 trusts for the same purpose. The first pair maintains numbered brokerage accounts, and only at the end of the year are the beneficial owners identified. In this way innumerable transactions are carried on, often between accounts, which do not actually affect the beneficial interests of their owners, but which are designed solely to reduce tax liability.

7. *The Device of Husband and Wife or Father and Children Partnerships*

"The purpose of these partnerships, like the multiple trusts, is to split the family income artificially into two parts; or, if the children are taken in, into still smaller fractions.

"There are many instances of this kind; but to illustrate the point, it is sufficient to cite the case of a New York brokerage firm which late in 1935 admitted into partnership the four minor children—two boys and two girls—of one of the partners. The tax saving he sought thereby in 1936 amounted to over $50,000.

8. *The Device of Pension Trusts*

"For 10 years the revenue acts have sought to encourage pension trusts for aged employees by providing corporations with a special deduction on account of contributions thereto, and exempting the trust itself from tax. Recently this exemption has been twisted into a means of tax avoidance by the creation of pension trusts which include as beneficiaries only small groups of officers and directors who are in the high income brackets. In this fashion high-salaried officers seek to provide themselves with generous retiring allowances, while at the same time the corporation claims a deduction therefor, in the hope that the fund may accumulate income free from tax.

"Thus, in one case $43,000 is annually appropriated by the corporation to a pension trust for the benefit of its two chief owners. One of the coowners will retire at the age of 65 with a monthly pension of $1,725, and the other will retire at 60 with a monthly pension of $1,425.

"These eight types of tax avoidance are sufficient to show that there is a well-defined purpose and practice on the part of some taxpayers to defeat the intent of Congress to tax incomes in accordance with ability to pay. In some cases, the Bureau of Internal Revenue under existing law can establish a liability or, indeed, proceed on the ground of fraud; but many of these cases fall in the category of a legal though highly immoral avoidance of the intent of the law. It seems, therefore, that legislation should be passed at this session of the Congress in order to eliminate those loopholes which our preliminary investigation has proved; and that as a result of the further in-

vestigation this summer and autumn the next session of the Congress should finally close any further loopholes which may be discovered.

"In addition to these cases of moral fraud, there are three other major instances in which the law itself permits individuals and corporations to avoid their equitable share of the tax burden.

1. *Percentage Depletion*

"This is perhaps the most glaring loophole in our present revenue law. Since 1928 large oil and mining corporations have been entitled to deduct from 5 to 27½ percent of their gross income as an allowance for the depletion of their mines or wells, and the deduction may be taken even though the cost of the property has been completely recovered. Thus, in 1936, one mining company deducted nearly $3,000,000 under this provision, although it had already completely recovered the cost of its property.

"The amount of the deduction was a sheer gift from the United States to this taxpayer and its stockholders, and the revenue that we lost thereby was $818,000. Similar annual losses of revenue in the cases of a few other typical companies are $584,000, $557,000, $512,000, $272,000, $267,000, $202,000, and $152,000. The estimated annual loss of revenue due to this source alone is about $75,000,000. I recommended in 1933 that provision be eliminated, but nothing was done at that time; and it has since remained unchanged.

2. *The Division of Income Between Husband and Wife in the Eight Community-Property States*

"This is another major cause of revenue loss, which is unjustifiable because obtained at the expense of taxpayers in the 40 States which do not have community-property laws. A New York resident with a salary of $100,000 pays about $32,525 Federal Income tax; a Californian with the same salary may cause one-half to be reported by his wife and the Federal income taxes payable by the two will be only $18,626. The total loss of revenue due to this unjustifiable discrimination against the residents of 40 States runs into the millions.

3. *Taxation of Nonresident Aliens*

"The 1936 act eliminated the requirement that a nonresident alien (without United States office or business) should file a return; fixed the withholding rate for individuals at 10 percent; and freed the nonresident alien from taxation on American capital gains. Since the total Federal tax upon a citizen or resident amounts to 10 percent of his total net income at about $25,000 (in the case of a married individual with no dependents), the withholding rate has proved in practice to be too low as applied to wealthy nonresident alien individuals. There are a number of cases of nonresident aliens with large incomes from American trusts or with large American investments whose taxes have been cut to one-third or one-fifth of what they paid under the prior act.

"Thus, one American woman who married an Englishman had an income from this country in 1935 of nearly $300,000. Her tax for 1936 will, therefore, be approximately $30,000 as against over $160,000 under the prior law.

"Another American woman who married a Frenchman has an income of over $150,000 from American

trusts on which she paid a tax of about $55,000 in 1935. Her tax is reduced to about $15,000 by the 1936 law. Although the tightening of the withholding provisions in 1936 will tend to insure more revenue from nonresident aliens in the lower-income brackets, the present taxing provisions are not satisfactory as applied to nonresident aliens with incomes in the higher brackets.

"The problem of tax avoidance is not new. The Congress devoted particular attention to it in 1933 and 1934, and by legislation effectively put a stop to many evasive devices discovered then as having been in use. The practices outlined above can and should be stopped in the same way.

"In conclusion, I have two observations to make from the evidence before me. In the first place, the instances I have given above are disclosed by a quick check of comparatively few individual returns. As I have said before, most of the large corporation returns have not yet been filed. The general audit of 1936 returns is just beginning. Nevertheless, it is likely that the cases I have digested above are symptomatic of a large number of others, which will be disclosed by the usual careful audit.

"In the second place, the ordinary salaried man and the small merchant does not resort to these or similar devices. The great bulk of our 5,500,000 returns are honestly made. Legalized avoidance or evasion by the so-called leaders of the business community is not only demoralizing to the revenues; it is demoralizing to those who practice it as well. It throws an additional burden of taxation upon the other members of the community who are less able to bear it, and who are already cheerfully bearing their fair share. The success of our revenue system depends equally upon fair administration by the Treasury, and upon completely honest returns by the taxpayer.

"The disclosures are so serious that I recommend that authority be given to the Treasury Department with an adequate appropriation in order that a complete and immediate investigation may be conducted. The cost of such an investigation will be returned many times over to the Treasury of the United States.

"Faithfully,

HENRY MORGENTHAU, JR."

A feeling of indignation on reading this letter will, I am confident, be yours, as it is mine.

What the facts set forth mean to me is that we have reached another major difficulty in the maintenance of the normal processes of our Government. We are trying harder than ever before to relieve suffering and want, to protect the weak, to curb avarice, to prevent booms and depressions, and to balance the Budget. Taxation necessary to these ends is the foundation of sound governmental finance. When our legitimate revenues are attacked, the whole structure of our Government is attacked. "Clever little schemes" are not admirable when they undermine the foundations of society.

The three great branches of the Government have a joint concern in this situation. First, it is the duty of the Congress to remove new loopholes devised by attorneys for clients willing to take an unethical advantage of society and their own Government. Second, it is the duty of the executive branch of the Government to collect taxes, to investigate fully

all questionable cases, to prosecute where wrong has been done, and to make recommendations for closing loopholes. Third, it is the duty of the courts to give full consideration to the intent of the Congress in passing tax laws, and to give full consideration to all evidence which points to an objective of evasion on the part of the taxpayer.

Very definitely, the issue immediately before us is the single one relating to the evasion or unethical avoidance of existing laws. That should be kept clearly in mind by the Congress and the public. Already efforts to befog this issue appear. Already certain newspaper publishers are seeking to make it appear, first, that if an individual can devise unanticipated methods to avoid taxes which the Congress intended him to pay, he is doing nothing unpatriotic or unethical; and, second, that because certain individuals do not approve of high income-tax brackets, or the undistributed earnings tax, or the capital gains tax, the first duty of the Congress should be the repeal or reduction of those taxes. In other words, not one but many red herrings are in preparation.

But it seems to me that the first duty of the Congress is to empower the Government to stop these evil practices, and that legislation to this end should not be confused with legislation to revise tax schedules. That is a wholly different subject.

In regard to that subject, I have already suggested to the Congress that at this session there should be no new taxes and no changes of rates. And I have indicated to the Congress that the Treasury will be prepared by next November to present to the appropriate committees information on the basis of which the Congress may, if it chooses, undertake revisions of the tax structure.

The long-term problem of tax policy is wholly separate from the immediate problem of glaring evasion and avoidance of existing law.

In this immediate problem the decency of American morals is involved.

The example of successful tax dodging by a minority of very rich individuals breeds efforts by other people to dodge other laws as well as tax laws.

It is also a matter of deep regret to know that lawyers of high standing at the bar not only have advised and are advising their clients to utilize tax-avoidance devices, but are actively using these devices in their own personal affairs. We hear too often from lawyers, as well as from their clients, the sentiment, "It is all right to do it if you can get away with it."

I am confident that the Congress will wish to enact legislation at this session specifically and exclusively aimed at making the present tax structure evasion proof.

I am confident also that the Congress will give to the Treasury all authority necessary to expand and complete the present preliminary investigation, including, of course, full authority to summon witnesses and compel their testimony. The ramifications and the geographical scope of a complete investigation make it necessary to utilize every power of Government which can contribute to the end desired.

FRANKLIN D. ROOSEVELT.

THE WHITE HOUSE, *June 1, 1937*

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CARL SHOUP

Married Couples Compared with Single Persons under the Income Tax

WHETHER a progressive income tax should be based upon family income or the separate incomes of the members is a difficult question of personal-income-tax policy. The many aspects of this problem have been well analyzed by Carl Shoup as follows: *

Whether a married couple should be treated as a single taxpaying unit under the income tax is a question frequently discussed, especially when plans for raising additional revenue are being considered. For instance, it is sometimes argued that a married couple should be required to file and pay tax on a joint return instead of being given an option to file separate returns. A somewhat similar proposal is that a married couple should have a personal exemption no more than twice as large as that of a single taxpayer. It is the purpose of the present discussion to indicate that the logical implications of either a simple yes or no answer are somewhat complex, and that the action the legislator will want to take must depend largely upon factors that vary from one tax jurisdiction to another—chiefly the treatment of imputed income under the tax law and the division of control, actual and potential, of the family's total income between the spouses. To restrict the area of discussion, constitutional inhibitions are not taken into account, and dependents are not considered. First there will be described the techniques available for treating a married couple like, or different from, a single person. Some hypothetical cases will then be posed to bring out the chief issues, followed by some conclusions of a very general nature.

Form of Return

So far as the form of return is concerned, the extreme of treating a married couple exactly as one taxpayer is reached when all income of each of the spouses is required to be lumped and computed as a single block of income (compulsory joint return). This procedure is common abroad but is not used in the United States.[1] Under a progressive rate

[1] So long as husband and wife are living together, this method is required in Great Britain (*Tolley's Complete Income Tax, Sur-Tax, etc., Chart-Manual of Rates, Allowances and Abatements for 1939–40* [British Income Tax], London, 1938, p. 87), for the French general income tax (Francis Deák, *Income Tax Laws of France*, prepared in the office of the General Counsel for the Department of the Treasury, Washington, D.C., 1938, pp. 11, 42), and in Germany (Office of

* *The Bulletin of the National Tax Association,* XXV, No. 5 (Feb. 1940), 130–35.

scale the result is of course a larger tax than if some part of the combined income were reported separately.[2] Certain special features in the tax law may produce the smaller tax under the joint return, as when losses of a certain type can be offset only against gains of the same type, and one spouse has the losses while the other has the gains. In general, however, a joint return means a larger tax.

A step away from the compulsory joint return—away, in the sense that it will on the average reduce the tax payable (assuming unchanged rates) —is the system whereby each spouse may file a separate return including therein the wages, salary, etc. that he earns and the interest, etc. received from his own investments. This is the method commonly followed in the United States.

Still further from the compulsory joint return are the community property systems in some of the western and southern states. Here the reporting is on a separate-return basis, and the earnings of each spouse during marriage are considered to be one-half his income and one-half the income of the other spouse. Similarly, the income from property representing savings from community earnings is itself community income. On the other hand, income from property owned before marriage is wholly the separate income of the owning spouse. Details differ among the community property states; and indeed the other states cannot be segregated in a uniform group. In general, however, substantial savings under the Federal income tax accrue to married couples in the community property states compared with married couples elsewhere and with single persons everywhere; hence the importance of the issue, which has been widely debated in recent years.

The community property system will not always result in an equal division of the total family income and hence will not give the maximum tax saving. This end would, in general, be achieved by a system under which the spouses added their incomes and divided by two, each computing a tax on his one-half share. No income tax jurisdiction, so far as the writer is aware, uses this method.[3]

In the discussion thus far the systems have been tested by the absolute amount of tax saving, it being assumed, for simplicity in exposition, that the rates and exemptions remain constant. Actually, as the tax revenues, under a given rate scale, shrink owing to the adoption of a system more favorable to the married couple, the rate scale is apt to be increased, if the government's needs for revenue remain unchanged. Still, a saving to the married couple results; the increased rate scale applies to the single person also. The same total tax revenue is to be raised, and

General Counsel for the Department of the Treasury, *German Income Tax Laws,* Washington, D.C., 1938, p. 14), but not in the United States, except, prior to the Supreme Court decision in *Hoeper* v. *State Tax Commission of Wisconsin,* in Kentucky (Sec. 13 (1), Income Tax Law, approved May 8, 1936) and Wisconsin (Secs. 71.05 (2) (d), 71.09 (4) (c), Chapter 71, Wisconsin Statutes, 1937).

[2] The present discussion is not concerned with separate—as compared with joint—liability for payment of the tax (the total amount of tax remaining unchanged). Cf. "separate assessment," *Report of the [British] Royal Commission on the Income Tax,* Cmd. 615 (1920), Pars. 249–50.

[3] Attempts by taxpayers to approach this goal by assignment of income have been blocked for the most part, in the United States at least. Roswell Magill, *Taxable Income,* pp. 248–67.

the married couples will pay a smaller proportion of it than before.

Personal Exemptions

The type of personal exemption used affects directly the relative tax paid by married couples and single persons. Here, the extreme of treating a married couple as one taxpayer is reached when the married persons together are given exactly the same exemption as the single person. This practice is not common.[4]

A step away is to give the married couple a larger exemption than the single person. The most restricted procedure under this general category would be to make the difference between married-couple tax and single-person tax vanish before the income reached the point where the rates became graduated. Thus all taxpayers with less than $10,000 income, under a rate scale that became graduated above the $10,000 level, might be given an exemption of $2,000 (married) or $1,000 (single), but taxpayers with $10,000 or more, no exemption at all. Here the difference between the married couple's tax and the single person's tax is constant until it vanishes at the $10,000 level. No taxing jurisdiction, it appears, uses this particular method of restricting the advantage the married couple gains by the larger exemption.

A less restrictive method is to allow the difference in tax to persist indefinitely up the income scale, but never to increase.[5] This can be accomplished either by taking the personal exemption always out of the lowest rate bracket (assuming the tax-rate scale is of the commonly used marginal-rate type, not a series of over-all rates) or by expressing the exemption as a fixed sum to be deducted directly from the tax itself. The former method is used in Great Britain, in effect; [6] the latter in several of the States. For example, if the exemptions in the illustration were always taken out of the lowest bracket, and if the rate scale became progressive at $10,000, the difference in tax would be uniform up to $10,000, and likewise beyond it indefinitely. Alternatively, the exemption might be expressed as a credit of, say, $100 for married couples' joint returns and $50 for single returns; if the tax rate in the lowest bracket (of $2,000 or more) were 5 per cent, these credits would be equivalent to $2,000 for a joint return and $1,000 for a single return, taken always out of the lowest bracket. In passing, it may be noted that this credit device, or the restriction of the exemption to the lowest bracket, is sometimes supported on the grounds that a wealthy taxpayer will otherwise get

[4] It is followed under the French income tax as concerns the schedular taxes, not the general income tax. Deák, *op. cit.*, p. 12. The tax on industrial and commercial profits (*ibid.*, pp. 16–26), the taxes on income from buildings and from unbuilt lands (*ibid.*, pp. 57–70), and the tax on income from securities and investments (*ibid.*, p. 86) allow no personal exemption; the agricultural profits tax, 2,500 francs (*ibid.*, p. 32); the salaries and wages tax and the tax on non-commercial occupations, 10,000 francs (*ibid.*, pp. 34, 38).

[5] An intermediate case of course is to allow the difference to persist beyond the point of graduation but at some point decrease to zero, suddenly or gradually.

[6] A married couple can deduct £180 in computing the base for the standard rate, which is, with a minor exception, a flat rate, while the single taxpayer deducts £100 (£125 if his total income is less than £140); but neither can deduct anything in computing the amount subject to surtax. If the wife has earnings, the £180 may be increased by four-fifths of such earnings, but not by more than £45 (Tolley, *op. cit.*, pp. 4, 23).

more dollars of tax relief from a personal exemption than a poorer taxpayer. But if, all things considered, the wealthy one is paying too small a tax compared to the less wealthy, the matter is easily remedied by raising the upper-bracket rates of tax. The argument is unfortunate in that it obscures the one point on which the credit device, or the restriction of the exemption to the lowest bracket, is decisive in comparison with the ordinary type of exemption to be described, namely, the difference in tax between married and single persons at various income levels.

A further step in relieving married couples of tax compared to single couples of the same income is to allow the difference in tax at any one income level to increase as the income goes up through graduated-rate brackets. This can be accomplished by allowing the personal exemption to be taken out of the highest bracket (assuming, still, a larger exemption for the married couple than for the single taxpayer). This is a commonly employed device.[7] Thus if a taxpayer has $20,000 of income, and the tax rate is 5 per cent on the first $10,000 and 8 per cent on the second $10,000, the taxable income, under a $2,000 exemption, is $18,000, of which $10,000 is taxed at 5 per cent and $8,000 at 8 per cent, a total of $1,140. Since the single taxpayer gets only $1,000 off, the difference in tax is $1,220 minus $1,140, or $80, while if both had an income of only $10,000 the difference in tax would be only $450 minus $400, or $50.

Finally, the furthermost step is to increase the spread between the exemptions themselves, as income increases (always taking the exemption out of the top bracket). Thus the married exemption in the example might rise to $3,000 in the $10,000–$20,000 range, the single exemption remaining at $1,000. Then the tax spread at $20,000 would be $160 instead of $80. No taxing jurisdiction, it appears, has adopted this method.

Miscellaneous Factors

Aside from the form of the return and the type of personal exemp-

[7] It is used in the Federal law, in many of the States, and in France as to the general income tax (not the schedular taxes), where a single person's exemption is 10,000 francs and a married couple's, 15,000 francs. But the tax otherwise due is increased by 30 per cent if the taxpayer is over 30 years of age and is unmarried, widowed, or divorced and has no dependent children. (Deák, *op. cit.*, p. 12.) The German law uses a device which seems to amount to about this kind of technique. The law sets forth a table of tax payable within each income class, and the tax is, at any one level, highest for a single person, lower for a married couple, still lower for a married couple with one child, etc. The spread in tax between single and married increases, both absolutely and as a per cent of income, as income increases. (*German Income Tax Laws*, pp. 27–29).

In this connection the peculiar definition of a "non-single" person under the German law is of interest. In addition to a married couple living together, it includes

"(a) Persons who are entitled to reductions for children;

"(b) Men who completed their 65th year at least four months before the end of the calendar year, and widowed and divorced men whose marriage resulted in a child which is not a Jew or who have completed their 50th year at least four months before the end of the calendar year;

"(c) Women who at least four months before the end of the calendar year have borne a child which is not a Jew or have completed their 50th year;

"(d) Orphans who have not yet completed their 25th year and are being trained for a vocation. These conditions must have existed simultaneously for at least four months in the calendar year." (*German Income Tax Laws*, pp. 24–25).

tion, some miscellaneous factors commonly influence the tax of a married couple compared with that of a single person.

If an earned income allowance is granted, and a joint return is filed, it is necessary in some cases to decide whether it shall be applied as if only one taxpayer were making the return. For instance, the earned income provision may limit the relief to earned incomes of $5,000 or less, and the husband and wife may each be earning $5,000. The question then arises whether the relief shall apply to $5,000 or $10,000.

One spouse may have nothing but deductions; a joint return then lowers the family's total tax compared to separate returns. Similarly, one spouse may have deductions of a type that can be offset only against income of a type that he does not receive the same year, as when capital losses can be offset only against capital gains.

Basis of Choice Among Forms of Return and Types of Exemption

The choice among the forms of return and types of exemption will presumably be dictated in large part —short-term political considerations aside—by a decision on the extent to which the married couple should be treated as a single taxpaying unit. That this decision is not a simple one, and may not result in a simple plan, will be evident after considering a few specific cases.

1.—M, W, and S, each single persons, are each earning X dollars a year; M and W then marry, and continue to earn as before, spending on a cook or maid somewhat the same amount they used to spend as the service element in their restaurant and lodging expenses, their scale of living remaining about the same. If rate graduation starts immediately above the X-dollars level, and a joint return is required, they will together have to pay more tax than before. From the viewpoint of the individual sacrifice required, there is no evident reason why they should be asked to pay this additional amount. M and W are each on the same economic footing as S; they should, from this point of view, pay the same tax as S. They will not do so unless separate returns are permitted and a personal exemption of twice that of S is split equally between them. Otherwise, part of what is really nonluxury income will be put up into a quasi-luxury tax-rate bracket.

2.—W, after marriage to M, does her own housework and as a result earns only X–V dollars; however, their standard of living remains about the same as before, since W's lessened money earnings are counterbalanced by the work she does at home. Under separate returns and an equally divided exemption, M and W, on the average, have a tax advantage over S—an advantage that is not justifiable from the point of view of their economic situation. The advantage of course disappears if the imputed income of W (the value of her housework) is taxed, but in fact no income tax law attempts to tax this form of imputed income. Splitting M and W's combined money income equally on separate returns would tend to increase the tax advantage over S, if rate graduation started below the X dollars level. Whether the forcing of a joint return on M and W would just counterbalance the advantage derived from the tax-exempt status of the housewife's imputed income would depend on the sizes of the various

incomes under consideration (assuming a certain rate scale); exact counterbalancing would occur in only rare cases if at all.

3.—If W gives up her job entirely, hence getting no money income, and utilizes the time thus released in leisure and in various household activities that neither M nor W experienced while single, the problem becomes one to be discussed under imputed income with respect to leisure. The problem diminishes in importance to the extent that W's action enables M to devote more attention to earning a money income and thus to increase it above X dollars.

4.—If the incomes of M, W and S are very large, the comparison becomes less distinct; it is then a matter of whether or not to shift part of the income, not from a necessaries tax-rate level to a quasi-luxury level, but from one luxury level to another (including painless saving as a luxury). Moreover, if the income is chiefly from investments, as is likely to be the case if the total is large, M and W may divide it between themselves by dividing the property, although the gift tax may be a deterrent.

5.—In addition, there are problems of the degree of control that M and W exercise, in law and in fact, over their own incomes. If M and W together earn just twice as much as S, but if M can and does control the income that W earns, and spends it on himself in luxuries while W is pushed down to a lower economic level than when she was single, there is not so strong a case for treating M (or W) just like S—that is, making the tax on M and W combined equal exactly twice the tax on S. If M can in law control W's income (as he does within wide limits even in most of the community property states) but if the money is not in fact spent any differently from what it would be if W had complete legal control over it, the case reverts to Nos. 1 to 4 as shown.

6.—If W was earning nothing before marriage (was living with her parents, for example) and earns nothing after, and M earns, after marriage, no more than he would have earned had he continued single, no case arises, so far as a comparison with S is concerned, for anything but a compulsory joint return with a personal exemption the same as that of S (assuming imputed income is not taxed). The "jointness" of the return is here, however, virtually without significance, since the wife has no taxable income. The problem at this point merges with that of allowance for dependents; W's family has lost a dependent, and M has obtained one. Whether M should be given a credit therefor depends on the treatment of imputed income.

7.—It may be argued that there is a case for heavier taxation of a married couple than of a single person. If in the instance given in No. 1 above it develops that two can live, per capita, more cheaply than one, through certain "large-scale economies" of consumption, M and W each has a money income available for luxuries that S, with the same individual income, cannot afford. Hence it may be argued that on the basis of economic power to support the state, M and W, should, combined, pay more than twice as much tax as S. This argument, however, has radical implications for the rest of the income-tax structure. In principle, it allows as a deduction the excess of one taxpayer's cost for per-

sonal consumption (taxpayer S) over that of another taxpayer (taxpayer M or W). If taxpayer B gets the same personal-consumption goods and services at a lower money cost than taxpayer C because B is more intelligent than C (not because B is married), should B on that account pay more income tax than C?

8.—If, both before and after marriage, M has a larger income than W, while S has an income somewhere in between the two; and if M and W are allowed to split the total family income equally in separate returns, though M still retains his own income for his own purposes and W hers for her own purposes—then S may feel aggrieved, since M has, in effect, been allowed to marry into a lower income bracket. But if W's income is very small, and M really devotes enough of his income to her so that they each do have about the same disposable amount as the other—and about the same as S—then the equal division of total family income for tax purposes may seem less unjust to S.

9.—The foregoing illustrations have compared a married couple with a single person. A comparison of two married couples is necessary to emphasize the possibility that one couple will be taxed more than another simply because the first couple gets its income to a greater extent from one spouse than does the other couple—a result that may occur when the taxpayers file separate returns as commonly conceived. Here the element of control, noted in No. 5 above, is pertinent. The differential in tax can be eliminated by requiring separate returns each of which contains one-half the family's total income. Alternatively, the differential may be allowed to exist on the grounds that, if the wife is not contributing money income she is contributing correspondingly more imputed income in housework, etc., that should be taxed in this indirect manner.

10.—If there is to be thoroughgoing separation of the spouses' incomes on the basis of the incomes that each actually earns or receives, a salary must be imputed to the spouse who works without pay in the other's business—the wife who helps in a small shop, for example. Otherwise her contribution appears in the net profits of the concern. No such adjustment would be needed, of course, in case the total family income were required to be split equally.

Some of the tentative conclusions that seem to follow from these considerations are:

First, whatever may be deemed the best method after weighing all the issues involved, it appears that a compulsory joint-return system may easily lead in practice to more inconsistencies than any other, so long as imputed income from labor is not to be taxed generally.[8]

Secondly, the return system that

[8] The conclusion of the British Royal Commission favoring the compulsory joint return seems to result, first, from an assumption that the only choice is between a compulsory joint return and separate returns of income actually belonging to each spouse (ignoring the possibility of an equal splitting of total family incomes); second, from a failure to consider in detail the effect of graduation in increasing the tax when two separate incomes are merged into one; and third, from a feeling that whatever discrimination the married couple suffered was eliminated by the increased personal exemption. Cmd. 615, pars. 248–62. The Commission does consider the possibility of a forced equal splitting of total family incomes, but only in connection with a splitting in which the children would share. *Ibid.*, pars. 263–65.

promises the most in avoiding inconsistencies may prove to be the one that at present is not used at all—*viz.*, the system whereby the married couple's total net income must be divided into two equal parts, each part being taxed separately.

Third, a return system that tends to put too much tax on a married couple may be improved by an exemption system of a kind that allows the difference in tax between married and single to grow as the income rises.

Fourth, the inconsistencies become less important or less certain as the total income rises.

Fifth, although it may be desirable to reach, if only indirectly, the imputed income represented by the wife's housekeeping activities, the compulsory use of some particular form of return can achieve this end only at the expense of extra taxation of money incomes, and the net result may be as unsatisfactory as not taxing imputed income at all. For example, it may be desired to tax M ($3,000 income) and his part-time employed wife W ($1,000 income) on a joint return basis because, compared with some single person who hires a maid, W is escaping taxation by not being taxed on the imputed income from her housework, and hence should not be allowed to put any of her income in the lowest bracket. If joint returns are, then, required of all married couples, and if another wife W earns $1,500 by working full time and pays $500 to servants to do the housework, the family with the smaller money income still has a tax advantage over the other. This effort to strike at imputed income by forcing a joint return causes unintended damage in still another case—i.e., where the wife's money income is from property instead of work. M and W, before marriage, may each be receiving $5,000 investment income, and M an additional $5,000 salary, while W is idle. After marriage the situation may be precisely the same, but if a joint return is compulsory the total tax will be larger.

Sixth, the personal exemption device may, in contrast to the form-of-return device, be used in a way that reaches the housewife's imputed income indirectly without involving extra taxation of money incomes in general, though the amount of tax thus levied on the imputed income would be erratic—scarcely ever the same as would be obtained if the imputed income were taxed directly. For instance, the wife and husband could each be given the same exemption as a single person, but the exemption of the wife would be deductible only to the extent of her own earned income.[9] If exemptions were $1,000 per person and if M earned $3,000 and W earned $1,000, both working full time, then the tax base would be $2,000, the same as if they were single. If W gave up her outside employment for housework, she would lose the $1,000 exemption and the tax base would still be $2,000; or if she worked part-time outside for $600 and part-time at housework, she would get a $600 exemption and the tax base would still be $2,000. The method assumes that the amount of the imputed income from housework can be adequately represented by a fraction of the personal exemption and that the earning of an outside income will prevent W from doing an identical amount (in money terms) of housework, except as overtime work that diminishes lei-

[9] See the British provision, note 7.

sure income. The technique is obviously far from satisfactory, but the point at issue is whether it may not be somewhat better than a failure to tax imputed income at all.

Seventh, the choice among the devices available depends to some extent on the actual degree of control each spouse exercises over his income. This is an institutional factor that will require special study before any particular technique can be recommended for a given time and place.

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COMMITTEE ON INTERGOVERNMENTAL FISCAL RELATIONS

Multiple Taxation in the Application of State Income Taxes

PROBLEMS of jurisdictional and territorial multiple taxation are encountered by both the federal government and the states in the use of the income tax, but they are much more important in the state sphere. Some of these problems as they arise in state income taxation are discussed below: *

(*i*) *Apportionment and other jurisdictional procedure.*

The possibilities of diversity in the apportionment of corporate income are very great. In practice, the diversity is considerable though not as great as sometimes supposed.

Some attempt at apportionment is required in the case of a foreign corporation. In the case of a domestic corporation, a State may tax the entire income, wherever earned. The grant of apportionment to domestic corporations is not within the constitutional requirement of due process. It is rather a concern of correct economic policy. To withhold from domestic corporations a concession granted to foreign corporations, whatever the basis for the action, is to put the former at a competitive disadvantage. In 1938, a committee appointed by the National Tax Association[1] to study the allocation of

[1] Leo Mattersdorf, chairman, "Report of the Committee of the National Tax Association on the Allocation of Income," *Proceedings,* National Tax Association, 1938, p. 486, and 1939, p. 190.

* *Federal, State, and Local Government Fiscal Relations,* Senate Document No. 69, 78th Cong., 1st Sess. (1943), pp. 426–431.

business income among the States found that of 32 States that levy corporate income taxes, 26 allow domestic corporations to apportion their income, 5 do not (New Mexico not classified).[2] In 2 of the States[3] where the income of domestic corporations may not be apportioned, a credit may be applied against the tax of the home State for the amount of taxes paid to other States on account of portions of income taxed in other States.

In agreement with the report of the committee of the National Tax Association on the apportionment between the States of taxes on mercantile and manufacturing businesses in 1922, the 1939 committee on allocation of income recommended that income from interest, dividends, royalties, and the sale of intangible capital assets be specifically allocated to sources within and without the State taxing the income. Nonoperating income is to be assigned to a given State if received in connection with business carried on in that State. If a definite allocation to a particular State in which the corporation may be doing business is impossible, such income is to be allocated to the State where the chief office of the corporation is located. Net income from rents and from the sale of tangible capital assets is to be allocated to the State where the property is located.

Eight States now permit the specific allocation of all nonoperating income and all capital gains and losses. Thirteen other States allow only certain types of nonoperating income to be treated differently from operating business income. Eleven States refuse to distinguish between types of income and tax total net income as a unit. The last group does not sanction any form of income allocation by accounting.[4]

Under some circumstances, most States permit the computation of net income by means of separate accounts, which are presumably designed to show only the income from business done in the taxing State. Some States apply separate accounting to as many corporations as they possibly can.

Of the 26 replies from State tax commissions that the Committee on Allocation of Income of the National Tax Association received with respect to separate accounting,[5] 9 stated that they preferred corporations to use separate accounting.[6] The other 17 preferred the formula method of allocating business income among the States. Nine States stated that they provided that the mathematical formula be used only as an alternative where separate accounting failed to achieve equity. The other 17 used the formula primarily, with most of them, however, permitting separate accounting as an alternative.[7] Where separate account-

[2] Alabama, Arkansas, Colorado, Louisiana, and North Carolina. New Mexico allocates overhead expenses, not gross receipts, and is treated throughout this section of the report as a special case.

[3] Alabama and Colorado.

[4] L. M. McBride, "Jurisdictional Aspects of State Income Taxation," *Taxes,* XVII, No. 4 (April 1939), 243.

[5] Six States did not answer this question: Colorado, Maryland, Missouri, New Mexico, North Carolina, and Vermont.

[6] Arizona, Arkansas, Idaho, Iowa, Kentucky, Louisiana, Mississippi, Oklahoma, and Wisconsin.

[7] William B. Wood, *An Analysis and Summary of Replies to the Questionnaire of the Allocation Committee of the National Tax Association* (mimeographed, Bureau of Government, University of Michigan, April 1939). Apparently three of the States, Ala-

ing is preferred, the commission said that requirements as to corporate records are usually so rigid that it is improbable that many corporations could qualify for the use of that method. Where the formula is preferred, separate accounting is generally discouraged by the taxing authorities.[8]

Proponents of separate accounting merely advocate its use where the accounting system adequately reflects the income status of what are almost separate businesses. What they fail to recognize is the significance of overhead costs, and the difficulty of apportioning correctly such costs. In addition, they overlook the fact that in relations between a parent corporation and a subsidiary, it is almost impossible to determine what constitutes a fair billing price. To resolve this question adequately, an integrated concern must sell not only to its subsidiaries but to independent concerns as well. Certainly there can be no separate accounting where no independent factory price is available.[9]

Allocation of business income by means of the apportionment fraction, i.e., by mathematical formula, has, therefore, come into widespread use. These formulas are designed to arrive at the fraction of such income that is reasonably attributable to a given State. They do so by allocating income in accordance with the ratio of certain business factors within and without the State.

The factors of the formulas vary widely between the several States and between classes of income in the same State. Tangible property and sales are the most popular. Ratios based on pay roll, manufacturing costs, and intangible property are strong second choices, and one State, North Dakota, employs "a business ratio," which is merely a conglomeration of purchases, pay roll, and sales. Where more than one factor is used, the percentage of net income assigned to the taxing State is equal to the weighted arithmetic average of the individual percentages of the several factors used. There is little uniformity in the weights attaching to various factors.

The 1939 committee of the National Tax Association found 16 formulas in use.[10]

Factors and number of States using these factors

1. Property, pay roll, sales....	10
2. Property, manufacturing costs, sales..............	7
3. Property, sales...........	8
4. Sales	8
5. Property, manufacturing costs	1

bama, New York, and Pennsylvania, do not permit separate accounting under any circumstances. While this is probably the practice, this position is necessarily false in theory. It runs counter to the Supreme Court decision in *Hans Rees' Sons* v. *North Carolina* (283 U.S. 123 (1931)), which ruled that if the taxpayer can show conclusively that the formula allocation procedure operates unfairly, he is entitled to a separate accounting, whether or not the statute gives it to him.

[8] Mattersdorf, 1939, *op. cit.*, p. 195. However, the opinion of the National Tax Association committee that very few corporations are likely to qualify for separate accounting is not supported by data. Professor Ford indicates that 46 percent of the corporations whose income is apportioned in Wisconsin were subject to separate accounting. R. S. Ford, *Allocation of Corporation Income for Purposes of State Taxation* (New York State Tax Commission, special report No. 6, 1933), p. 76.

[9] Ford, *op. cit.*, p. 34.

[10] Mattersdorf, 1939, *op. cit.*, p. 193.

6. Property, cost of sales, sales	1
7. Property, pay roll.........	2
8. Property, shares of other corporations, accounts receivable	1
9. Property, pay rolls, sales, purchases	1
10. Property	1
11. Manufacturing costs.......	1
12. Marketing costs...........	1
13. Property, pay roll, sales, manufacturing costs.....	1
14. Cost of sales..............	1
15. Property, pay roll, purchases	1
16. Loans, wages, interest.....	1

However, in the opinion of the committee, the 16 formulas exaggerate the impression of nonuniformity.

1. This number includes both general formulas and alternative formulas. The alternative formulas represent an attempt by the States to use the formula that is best adapted to a particular type of corporation, and not a different treatment of the same type of corporation.[11]

2. Formulas Nos. 1, 2, and 6, which are quite similar, are employed in 18 States. If the appropriate factor is added to formulas Nos. 3, 5, and 7, uniformity will have been achieved in 23 States. On the other hand, it may be argued that the 16 formulas understate the extent of nonuniformity. For instance, while the committee of the National Tax Association found 16 formulas in use, 1 corporation claimed to be subject to 30.[12] The corporation may be overstating its compliance difficulties. But there are differences in the statutory definitions of the factors entering the 16 formulas, in the weights attached to the factors, and in the method of arriving at net income, which may really result in a need for the determination of income in the several States by as many as 30 different methods.

It appears that most of these formulas have not been significantly revised since their adoption. However, some States have changed from a one-factor to a multiple-factor formula.[13]

Various committees of the National Tax Association, since 1922, have wrestled with the problem of apportionment factors, seeking the ideal combination to recommend.[14] The 1939 committee, following in the main the views of its predecessor (committee appointed 1930; report, 1933), recommended the allocation of the income of mercantile or manufacturing businesses by means of the Massachusetts formula. Purchases were excluded from the recommended formula because they readily lend themselves to manipulation. A corporation can usually manage to locate the situs of purchases at the head office.

The Massachusetts formula, which accords equal weight to the three factors, tangible property, pay roll, and sales, has these advantages: it and its modifications are widely used; its factors are easily ascertainable, involving no allocation of overhead costs; it is on the average no less equitable than any other arithmetic formula; it has been satisfactorily tested in the light of Massachusetts

[11] It is still possible, of course, for one corporation to take on different characteristics and therefore be subject to different formulas in the several States.

[12] Mattersdorf, 1939, *op. cit.*, p. 200.

[13] Connecticut and Tennessee. Wood, *op. cit.*, pp. 7–8.

[14] Herbert Klarman, *Personal and Business Net Income Taxation in the States,* monograph prepared for this report.

experience; and its legality has been upheld.[15]

The formula suffers, of course, from disadvantages. The property factor generally fails to include the value of rented property employed in the business, which exerts economic effort toward the creation of income. Since the tax on the corporation is related to volume of the business, rented property should be included. An alternative would be to follow Connecticut practice and disallow the deduction, for purposes of determining net income, of rent or interest paid out by the corporation. However, if rent income is specifically allocated to the State of the property's situs, the property from which the rent income is derived should be excluded from apportionment.

There are also many who contend that the use of the pay-roll factor to supplement property and sales simply adds a greater weight to manufacturing than to selling and results in the manufacturing ratio being weighted at two-thirds in the allocation fraction.[16] Even if this allegation were true, the bias introduced by the pay-roll factor is less than would be caused by a cost-of-manufacturing factor. Perhaps the fault is not with the third factor; it may lie with the property factor, which is hardly indicative of business activity.[17] Still, the property factor is probably too widely entrenched to be cast aside when uniformity is sought.

The individual components of the Massachusetts formula require some elaboration. The treatment of the pay-roll factor is generally satisfactory.[18] Wages and salaries are apportioned to the office in which the employee works or the State where the office out of which he works, or with which he is connected, is located.

However, there is wide variation in the definition of the sales factor.[19] The committee on income allocation of the National Tax Association considered six methods of allocating sales to a State: [20] (1) The State to which payment for the sale is made, (2) the State from which the goods are shipped, (3) the State to which the goods sold are shipped, (4) the State from which the salesmen making the sales function, (5) the State where the order is accepted, (6) the State from which the billing is made.

The committee disapproved of methods (1) and (6), because neither the State to which payment is made nor the State of billing appears to make a significant contribution toward the earning of income.[21] Methods (2) and (5) were also opposed,

[15] *Turco Paint & Varnish Co.* v. *Kaloder* (320 Pa. 421, 184 Atl. 37 (1936)).

[16] Ford, *op. cit.*, p. 60.

[17] McBride, *op. cit.*, p. 244.

[18] Mattersdorf, 1939, *op. cit.*, p. 208.

[19] *Ibid.*, p. 208. Ford, *op. cit.*, p. 95. Wood, *op. cit.*, p. 7, says: "Differences in the definition of the sales factor are probably a greater source of nonuniformity than the differences between the pay roll, manufacturing costs, and cost of sales factors."

[20] Mattersdorf, 1939, *op. cit.*, p. 209.

[21] The committee set up economic effort in the State as the criterion of the State's jurisdiction over an allocation factor. "When taxing net income or franchises whose values are measured by net income, the States are not taxing the gross receipts or sales but are directly or indirectly taxing the net income which is the result, not only of the sales, but of every other activity leading up to the sale in which the taxpayer may be engaged. The States, in the use of factors in a formula, whether they be tangible property, pay roll, sales, or any other, should be guided by the economic effort that produces the income. It is this economic effort evidenced by activity in various States that produces the net result, namely, net income." *Ibid.*, p. 209.

for different reasons. The State from which the goods sold are shipped receives ample consideration in the property factor of the formula, and also in the general property tax. Furthermore, if the shipment is made from a warehouse owned by someone else in a State where the taxpayer is not engaged in doing business, the State cannot exercise jurisdiction to tax. To locate the situs of a sale at the place where the order is accepted is objectionable because of the absence of economic effort at that point and because of the possibility of manipulating this place. True, this method has been given great weight in legal decisions.[22] However, the committee felt that "no definite principle is enunciated [by the courts] or can be taken as a guide." [23]

The committee approved of methods (3) and (4) and recommended that they be used together: "It is recommended that each sale be divided into two equal parts and that 50 percent of the amount of each sale be apportioned to the State of destination of the merchandise shipped by the taxpayer, and 50 percent to the State from which the salesmen making the sales function." [24]

This method of allocation has not been applied by any State, probably for legal reasons. The committee agreed that the State of destination might be without the power to tax. However; the State of destination factor is only one-half of sales, and a much smaller percent of total income. The occasional escape of this small fraction was not thought to be serious, especially since in most cases it may be expected that the corporation will usually be doing business in the State of destination, and therefore be subject to tax.[25]

There is also a difference of opinion and practice as to whether one formula should be used for all corporations. A possible alternative is to apply different formulas to different types of corporations. This involves possibilities of diverse treatment in the classification of corporations. Also, varying degrees of discretion to depart from established formulas in exceptional cases may be allowed administrators.

A small minority of the States, three in number, have decided that over-all substantial justice suffices, and have devised apportionment formulas from which the tax authorities may not deviate.[26] At the other extreme are a small group of States, eight in number, who have left all discretion, including the devising of the formulas, with the tax commis-

[22] *Norfolk and Western Railway Company* v. *Sims* (191 U.S. 441 (1903)). *Compania General de Tobacos de Filipinos* v. *Collector* (279 U.S. 306 (1929)).

[23] Mattersdorf, 1939, *op. cit.*, p. 213.

[24] *Ibid.*, p. 214. T. R. Powell made a similar suggestion in 1925, "Business Taxes and the Federal Constitution," *1925 Proceedings*, National Tax Association, pp. 164 ff. In a sense this suggestion is similar to the practice of some States, such as New York, Vermont, and Virginia, which construe sales to mean the sale of goods within the State, wherever manufactured and the sale of goods manufactured within the State wherever sold (Ford, *op. cit.*, p. 94). This double definition of sales is identical with the rule proposed by the committee of the National Tax Association if the sale of goods within the State, wherever manufactured, refers to the State of delivery and the sale of goods manufactured within the State, wherever sold, refers to the State from which the salesmen function.

[25] *Ibid.*, p. 216.

[26] Arkansas, Connecticut, and New York cannot under their constitutions permit the tax administrator to formulate apportionment fractions. Arkansas goes further, not even permitting the equitable adjustment of the statutory formula. Wood, *op. cit.*, p. 17.

sions.[27] Between these two extremes lie the mass of State laws. In some, apportionment is made by taking the arithmetic average of several ratios, but permitting the tax commission, when petitioned by the taxpayer, to authorize the use of a more suitable ratio selected from a group of statutory ratios. In others, the same selectivity is available to a commission on its own motion if, in its opinion, strict mathematical apportionment does not properly reflect net income allocable to that State.[28] The majority of the laws, in fact, specify in one section what ratio or ratios are to be employed, and in the next section grant to the tax commission a blank check to be filled in with any method of apportionment that, in the opinion of the commission, will attain the proper result. Such provisions have generally been sustained.[29]

It will be recalled that apportionment of corporation income is but one of the jurisdictional problems created largely by the diversity of State procedures. Some States tax personal income where earned and others at the residence of its recipient. And residence itself is variously defined. Credits to residents or nonresidents are sometimes allowed, but these also vary from State to State.

[27] With respect to foreign corporations, eight States leave the determination of the apportionment formula to the administrator. The States are: Alabama, California, Idaho, Louisiana, Mississippi, Montana, Oregon, and Vermont. Of these, six treat their domestic corporations similarly. Two others, Alabama and Louisiana, do not permit their domestic corporations to apportion income.

[28] The Committee on Uniformity and Reciprocity, 1933, suggested that where one or two of the allocating factors appear to be inapplicable, the remainder of the net income be allocated by the remaining two or one factors. However, a factor is not inapplicable merely because the numerator of a fraction is zero. Only if both the numerator and denominator are zero is the factor inapplicable (*1933 Proceedings*, National Tax Association, pp. 265–66). Pennsylvania employs this procedure.

[29] Faced with the dilemma of prescribing formulas so rigid in their application to any and all types of business that they are likely to be held unconstitutional for denying due process, or making the apportionment specifications so vague or pliable as to be endangered by attack on the grounds of an illegal delegation of power by the legislature, the States have usually chosen the latter risk. Two decisions have discounted the risk: *United Advertising Corp.* v. *Lynch,* (63 F. (2d) 243 C.C.A. 2d., (1933)); *Western Union Telegraph Co.* v. *Query,* (144 S.C. 234, 142 S.E. 509 (1927)). A third turned the risk into reality and voided such a section in the New York law: *B. P. Ducas Co.* v. *State Tax Commission,* (260 N.Y. 525, 184 N.E. 77 (1932)). Still other courts have reminded tax commissions that they cannot embark on an apportionment scheme of their own, at least in the absence of a statutory authorization to do so: *Fisher* v. *Standard Oil Co.,* (12 F. (2d) 744 C.C.A. 8th, (1926)); *Commonwealth* v. *P. Lorillard Co.,* (129 Va. 74, 105 S.E. 683 (1921)); *Ford Motor Co.* v. *State,* (65 N.D. 316, 258 N.W. 596 (1935)); *State Revenue Commission* v. *Edgar Bros. Co.,* (55 Fa. App. 505, 190 S.E. 623 (1937)). See McBride, *op. cit.,* p. 245, note 60. Perhaps the belief that flexibility would be to the advantage of the State treasury has been another factor making for vague legislation in this field.

COMMITTEE ON INTERGOVERNMENTAL FISCAL RELATIONS

Suitability of the Income Tax as a Source of State Revenue

MANY believe that income taxation should be the exclusive prerogative of the federal government and that it is unsuitable for use by the states. This issue is discussed below:*

4. *Problems of Suitability in State Income Taxation*

(*a*) *Factors of Suitability.*

Income-tax revenues tend to vary substantially from year to year, although less than death-tax revenues. Income taxes tend to be very cycle sensitive and fluctuate with business prosperity. Also, unlike the inheritance tax, the fluctuations from year to year may be no greater for a State than for the Federal Government, though the latter has the advantage in that gains and losses in different parts of the country tend to offset each other. Applied to as small a unit as most cities and counties, the graduated personal income tax produces quite unstable revenues, and this factor combined with those of territorial competition and administrative difficulties renders the tax not well adapted to local use. However, a tax with very low exemptions, or none, and a flat rate, like the Philadelphia tax, may be reasonably satisfactory from the standpoint of steadiness of yield.

Perhaps the greatest complication in State taxation of income is that of determining what belongs to the tax base geographically. The problem is as great for the taxpayer as for the States. As previously explained, a variety of rules and procedures applied by the States to establish jurisdictional boundaries in income taxation results in substantial multiple taxation. Just how much is, unfortunately, largely a matter of conjecture. There seems little likelihood that the Supreme Court can be relied upon to clear up this injustice and impediment to cosmopolitan business. Uniformity movements and reciprocity legislation make only a small dent on the problem. Here is a matter that a coordination program should aim to alleviate. Within the jurisdictional problem, and to a certain extent beyond it, lies the contention that income, realized at one point but derived from a broad market and in a national economic system, should be taxed for the benefit of all the people or at least for the benefit of a wider population than that of one State.

An important factor in State in-

* *Federal, State, and Local Government Fiscal Relations,* pp. 434–437.

come-tax development is the migration of wealth and industry, and propaganda concerning the alleged effects of the tax on economic development. This has been discussed in an earlier section of this report. Probably no factor has had so much weight in retarding the development of the State income tax as this.

In many States (including some of the wealthiest and most populous) there are impressive legal and constitutional barriers to income taxation. For example, Illinois passed an income tax in 1932, but it was declared unconstitutional by the State supreme court. The court took the view that income is property and thus subject to a uniformity clause in the State constitution. The Illinois Constitution is notoriously difficult to amend. The same situation prevails in several of the other non-income-tax States.[1]

With prevailing types of legislation and techniques of administration, it is impossible to make the income tax a very effective revenue producer in an agricultural State. The income tax is primarily an urban tax, and depends substantially upon an unequal distribution of wealth for its productivity. This is not to say that it is impossible to get large revenues in a poor rural State with relatively even distribution of income. But certainly the techniques for so doing, or perhaps the courage to try, have still to be developed. Thus, while the net-income tax in North Dakota has been the subject of acrimonious debates, the yield of the tax in that State has been a mere trifle compared with that of the property tax or the motor-vehicle taxes.

State income-tax administration is spotty in character. Some of it is at least as good as, and perhaps superior to, the Federal. But in many States, low personnel standards and starvation appropriations make the product far below what it should be.

Robert M. Haig has listed four "State-line" obstacles to efficient State tax administration: [2]

(1) *Interstate commerce.*—It is difficult for the States to impose a tax on interstate commerce. Many of them have therefore come to favor the delegation of more tax functions to the Federal Government. It appears that this difficulty relates principally to goods in transit; it is of minor importance for the income tax.

(2) *Localization of tax base.*—It is difficult to localize the tax base. Economically, it is difficult to determine the particular areas in which the profits of a far-flung business enterprise arise. Legally, there are obstacles to be overcome in the commerce clause and the due process clause of the Federal Constitution.

(3) *Interstate tax competition.*—Given a mobile tax base, the States may indulge in competitive bidding

[1] Fear of judicial invalidation has hampered the income-tax movement considerably. Washington has made several attempts at income taxation, but the State courts have repeatedly upset the enactments of the legislature. In Indiana, fear of nullification prevented even initial enactment.

Some of the States which now levy income taxes also had to overcome judicial resistance. Alabama, Minnesota, and Oregon are in that group. While Pennsylvania now levies a corporation franchise tax, measured by net income, its personal income tax was voided by the State supreme court. See Richard A. Girard, *The Scope for Uniformity in State Tax Systems* (Albany, 1935), pp. 114 ff.

[2] Robert Murray Haig, "The Coordination of the Federal and State Tax Systems," *1932 Proceedings*, National Tax Association, pp. 225–228.

for it. It is not clear whether such bidding actually induces migration. However, if the States think that it does, they will not exploit their fiscal potentialities to the utmost.

(4) *Uneconomic administrative district.*—Some States have low taxable capacity. Modern streamlined State tax administration would not pay.

Probably the first of these difficulties is not very serious for the income tax. That the States need assistance from the Federal Government as to the other three must be conceded.

(b) Should the States Continue in the Income Tax Field?

There are many who believe that the income tax is an excellent source of revenue for the Federal Government, but that the States should stay out of this field. It is conceded by all that central units of government have many advantages over their subdivisions in the administration of the tax. On the other hand, it is argued that the income tax is too important and meritorious a means of revenue to be ignored on so large a front of expenditure as the States and municipalities represent. The latter provide most of the prime essentials of government, including such personal services as education, which very properly might be supported by a personal tax on net income. Most important, perhaps, is the fact that the income tax provides the one important available progressive tax by means of which the people of any State can eliminate or reduce the regressivity of their State and local tax systems. Unless independent State and local government is to disappear, some freedom in the choice of ways and means at the State and local level is exceedingly important. Some States are more inclined to apply the ability-to-pay theory than others and the State income tax gives them an opportunity to express this difference.

The State net income tax encounters heavy impediments of conflicting jurisdiction, multiple taxation, high compliance costs, uneconomical administration, and interstate competition. There are antidotes for all these limitations and none is so serious as to warrant a death sentence for the State income tax. It is true, of course, that the State income tax does less to correct geographical maldistribution than the Federal. The Federal tax coupled with a well-ordered system of Federal aid would be most effective as a corrective of geographical maldistribution. This device is now being applied to some extent but quite imperfectly; it can be further developed and improved to relieve the pressure for new revenue for State and local tax systems. But this does not mean that the States need to be ruled out of the income-tax field.

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CHAPTER 5

DEATH AND GIFT TAXES

PROPONENTS of capitalism have not been unanimous in support of the proposition that inheritance is an essential of the system; and even those who take the affirmative side of this issue would agree that the transfer of property from one generation to another is a proper occasion for some tax. Every important modern country has acted in accordance with this consensus. As usual in taxation, however, there is dispute as to the proper degree of the tax.

There is also dispute over the many problems in the application of this levy. Whether the tax should be the prerogative of the federal government, or the states, or both; how to prevent vicious territorial multiple taxation; what to do about avoidance through *inter vivos* gifts and trusts and powers of appointment—these are among the practical problems with which this chapter will deal.

Although tax students have usually agreed on the propriety of some death taxation, they have not reached the same conclusion as to the economic effects of the tax. Some hold that inheritance taxation is a case of "grinding the nation's seed corn" and that we should take care lest there be nothing for next spring's planting. Others are skeptical of the contention that death taxes are uniquely inimical to saving; they fear too much rather than too little seed corn.

The death tax has been only a minor source of revenue in the United States, but some postwar planners would give it a distinctly larger role. Hence it deserves our careful attention.

WILLIAM J. SHULTZ

The Estate Duty vs. The Inheritance Tax

DEATH taxes may assume two substantially different forms, each of which has a strong following. The nature of these two death-tax forms and the arguments supporting them are discussed by Professor William J. Shultz as follows: *

As must be evident from a reading of Part I of this study, two generally accepted methods of taxing inherited wealth have evolved—the estate duty levied upon the total estate left by the decedent, and the inheritance tax bearing upon the individual shares of this estate after it is distributed among the beneficiaries of the decedent. In the most elemental form of inheritance taxation—the probate duty—the two methods are fused, for the probate duty while levied on the total estate, might equally well be considered a lumped tax on the individuals' shares—particularly if it is at a proportional rate. As soon, however, as such discriminations as individual exemptions, collateral graduation, progressive rates, etc., are introduced, a divergence appears.

Of the two forms of the tax, the inheritance tax is at present the more widespread, and the estate duty is the newer. It is true that in England the probate duty was established a century before the legacy and succession duties, but the probate duty did not develop into a true estate duty until the end of the nineteenth century. Excepting the feudal *relief*, the early elemental probate duties, and such minor exceptions as the Bavarian *quarta peuperum*, the first true estate duties were those enacted by the Australian provinces in the seventies and eighties; the first in Victoria in 1870, followed by Queensland and New South Wales in 1886. In Canada, the Ontario, Nova Scotia, Quebec, and New Brunswick statutes of 1892 were likewise estate duties, although in a modified form. The great nineteenth century example of the estate duty, however, was the English tax of 1894.

After 1890 in the European countries there were numerous proposals for estate duties either to replace existing inheritance taxes or to supplement them. Most of these proposals came from the Socialist blocs in the legislative chambers, but not a few were introduced as administration measures—in Germany in 1908, in Italy in 1914, in Spain of recent years.[1] Since 1914, the spread of the

[1] Bernis, *La Hacienda Espanola*, p. 250.

* Reprinted by permission from *The Taxation of Inheritance* (Boston: Houghton Mifflin Company, 1926), Chap. 13.

estate duty has been quite rapid; the Commonwealth Government in Australia enacted a federal estate duty in 1914, the American Federal Government its estate duty in 1916, Rhode Island, Mississippi, Utah, and Oregon their estate duties during the next few years, republican Germany and Austria enacted estate duties accompanying their inheritance taxes in 1919, and the South African Dominion Government a combined estate duty and inheritance tax in 1922; the latest addition to the number is New York State in 1925 with its supplementary estate duty on estates above $1,000,000.

What are the advantages of the estate duty as against the inheritance tax? Champions of the estate duty have always extolled its greater simplicity and its greater revenue-producing ability. In so far as collateral graduation, individual exemptions, etc., are eliminated from an estate duty, it is relatively easier to compute than an inheritance tax embodying these features; moreover, it is possible for treasury departments to reckon with some degree of accuracy the revenue therefrom, since the vagaries of individual will-making are not involved. On the other hand, the estate duties of the Canadian provinces, in their straining towards greater justice in the matter of collateral graduation and progressive rates on the share received by the individual beneficiary, have achieved a bewildering complexity far exceeding that of the most poorly drawn American statute.

Of the greater revenue-producing ability of the estate duty there can be no question, particularly when progressive rates are involved. Were the rate schedules of an estate duty and of an inheritance tax identical, the breaking up of the total estate into the beneficiaries' shares for the purposes of the inheritance tax would prevent the application of the high rates of the upper brackets of the inheritance tax; while the estate duty, bearing on the united total of the estate, would necessarily subject it to the higher rates of these upper brackets. Moreover, the inheritance tax is indissolubly bound up with discrimination between classes of heirs on the basis of their relationship to the decedent. By far the greater part of inherited wealth passes to the direct heirs of the decedents, and it would be a bold legislature that would fix rates on inheritance by direct heirs even distantly approximating the rates that could be set for an estate duty where relationship discrimination did not enter. The insistence of the Socialist blocs in the French and German legislatures upon the imposition of estate duties was because they felt it was the only possible method of obtaining any significant revenue from property passing to the near families of decedents.

The subject of relationship discrimination will be discussed more fully in a later chapter, but it should be noted here that there are some economists who altogether deny the logic or advisability of such discrimination. Thus Paul Haensel points out that exemption of the direct heirs or even low rates upon them automatically cuts away the richest part of the tax, and that by enabling the decedent through division of his estate into many small bequests, to reduce the amount of the inheritance tax (that is, when the rates of the tax are progressive or there are exemptions allowed), the State permits the individual to determine the

amount of taxes he chooses to pay. Moreover, Professor Haensel insists that progressive rates and relationship discrimination do not go well together; through the combination of these principles, inheritances of the same size pay different rates, and the more rapid the progression the greater the difference—thus it comes about that the poor nephew of a poor laborer must pay a higher rate on his little inheritance than the rich son of a millionaire on his inherited millions. Professor Haensel concludes that the estate duty is the only just form of taxing inherited wealth.

From the standpoint of legal and economic theory, the estate duty can find quite as much justification as the inheritance tax, thanks to the bewildering confusion of theory in this field. If the tax be considered as levied on the decedent or on his right or privilege to transmit his property, then an estate duty would be the only logical conclusion; if it be considered a tax upon the heir and his right or privilege to receive his inheritance, then it should take the form of an inheritance tax. The American courts, the only ones to be much concerned with this problem, have swung from the one doctrine to the other, with the present tendency to justify the taxation of inherited wealth on *both* doctrines. The contention of some of the courts that inheritance taxation by the individual states is not so much a tax as the exercise of a feudal right of control over the property of decedents gives the state legislatures *carte blanche* to levy either form of tax.

Economists and fiscal theorists have found no difficulty in defending the estate duty when such was their intent. The 'cost of service' and 'value of service' theories lead most logically to probate duties and by a straining of the argument could be brought to the defense of a progressive estate duty. All the 'back tax' theories support the estate duty to the exclusion of the inheritance tax; if the taxation of inherited wealth is to be defended as a deferred income tax as in England,[2] or as a deferred property tax as in Germany,[3] it must take the form of a tax upon the wealth of the decedent as it was in his possession—in short, an estate duty. If the taxation of inheritance is intended not only to raise revenue but as a social weapon to effect a redistribution of wealth, it can be done almost as well by an estate duty as by an inheritance tax.

Opponents of the estate duty have presented equally vigorous arguments against it and in favor of the inheritance tax. The ultimate incidence of all taxation of inherited wealth, they have insisted, is upon the beneficiary. The testator, the original accumulator of the wealth, is dead and indifferent to taxes of any sort; only by an extreme straining of legal fiction can the estate he leaves be conceived to possess a personality and hence in itself pay the tax; it is the heir who finally pays the tax, for his share of the inheritance is less by the amount of the government's deduction. If the ultimate incidence of the tax is upon the heir, then the tax must be so organized as to satisfy the canons of justice from the point of view of the *heir*. The estate duty does not satisfy

[2] Sir William Harcourt in *Parl. Deb.*, XXIII, 489.

[3] See Dietzel, *Reichsnachlasssteuer oder Reichsvermögenssteuer?*, pp. 3–5, and Romniciano, *L'impôt successoral en Allemagne*, p. 18.

these canons of justice; where the rates of the tax are progressive, the determining element is associated not with the ability of the heir, but with the ability of the eliminated decedent. Such was the argument of the United States Supreme Court in the case of *Knowlton* v. *Moore* and the illustration it gave was as follows:

A person dying, and leaving an estate of $10,500, bequeaths to a hospital $10,000. The rate of the tax would be 5 per cent and the amount of the tax $500.[4] Another person dies at the same time, leaves an estate of $1,000,000, and bequeaths $10,000 to the same institution. The rate of tax would be 12½ per cent and the amount of the tax $1250. It would thus come to pass that the same person occupying the same relation and taking in the same character two equal sums from two different persons, would pay in the one case more than twice the tax that he would pay in the other.[5]

In the theoretical controversy, the 'value of service' argument has been marshaled to the support of the inheritance tax by insisting that the service performed by the State in assuring the transmission of the decedent's property is not to the decedent, who is beyond all earthly service, but to the heirs who otherwise might be robbed of their inheritance; therefore the tax should be based on the share of each beneficiary. All the 'back tax' interpretations of inheritance taxation, and all 'state inheritance right' theories are scouted by opponents of the estate duty. By the canon of the ability of the individual to pay, they insist, should the tax be judged.[6] Finally, those who are interested in effecting a broader distribution of wealth through the agency of the taxation of inherited wealth, point out that the existence of a progressive inheritance tax induces the testator to make many small or moderate sized bequests to a number of beneficiaries, rather than to transmit his entire estate to any single heir, since the total of taxes on the many small beneficiaries' shares will be less than the tax when the entire estate passes to a single heir; there is no such in-

[4] The Court is basing its argument on the rates of the American federal tax of 1898.

[5] *Knowlton* v. *Moore*, 178 U.S. 41.

[6] See Luigi Einaudi, *Corso di scienca della finanza* (Turin, 1916), p. 291 *seq*. The Australian Royal Commission on Taxation in its *Fifth Report* of 1923 summarized the arguments for the inheritance tax as against the estate duty as follows:

"(1) An estate may generally be taken as having paid, during the process of accumulation, its proportionate share of such taxes as Income Tax, Land Tax, and other charges incident to the acquisition and possession of real and personal property.

"(2) Tax is more properly leviable upon the person who acquires a new interest than upon the mass of property left by a person for distribution, possibly among many.

"(3) The trend of modern thought is in the direction of taxing a person in respect of his interest in something of value rather than of taxing the thing of value irrespective of its ownership or the destination of any beneficial interest derivable from it.

"(4) A true Succession Duty enables tax to be levied so as to avoid the harsh anomalies which inevitably arise under an Estate Duty —for example, under an Estate Duty the amount of tax leviable in respect of a particular legacy or benefit . . . may vary greatly according to the total aggregate value of the estate. . . .

"(5) A Succession Duty is simple in principle, as the acquisition of a new beneficial interest or of an addition to capital resources as the result of a testamentary disposition or its equivalent affords a clearly understandable basis of taxation.

"(6) A Succession Duty, which is a Duty not only charged upon, but also measured by the value of the interest devolving upon the taxpayer, rests upon a basis of *equity* which is absent in the case of an Estate Duty."

ducement to break up the estate when the tax is in the form of an estate duty.[7] Also, Professor Schanz points out that when the family of the decedent is large, the estate is broken into a number of fractions, and a progressive inheritance tax would bear only lightly on these small fractions; thus an inheritance tax is an indirect encouragement to larger families. An estate duty would offer no such encouragement.

Before passing final judgment on the estate duty, we should note some of its possible developments. In the first place, relationship discrimination and progression on the basis of the shares received by individual beneficiaries may be incorporated in an estate duty, as in the case of the New Zealand and Canadian statutes, although at the cost of complexity and confusion. When France decided to encourage larger families by levying a special discriminating tax in the case of decedents with but few children, she adopted the *taxe successoriale,* an estate duty, which is levied only when the decedent leaves less than four children, and which has four sets of rates, the heaviest applying when the decedent is childless, and the other three respectively when he possesses one, two, or three children. Another possible specialized use of the estate duty is the *Wehrsteuer,* an estate duty advocated in Germany to be levied only on decedents who had not performed their required military service. The Rignano project, to be studied later, would levy a special semi-confiscatory estate duty upon so much of the estate of a decedent as he had not earned by his own efforts, but had inherited or received in gift from others, on the theory that such a tax would stimulate all rich beneficiaries to labor on their own account in order to be able to transfer some wealth to their own heirs. In our own national Congress the suggestion had been made that a special estate duty should be levied upon so much of an estate as consists of tax-exempt bonds of the Federal Government, the states and the municipalities.

After eliminating far-fetched and incidental arguments, our final conclusion must be that the estate duty is the better revenue producer, while the inheritance tax is more abstractly just in the light of the currently accepted doctrine that taxes should be levied in accordance with the abilities of the taxpayers. Where the governmental agency, be it state or federal, looks upon the tax on inherited wealth as an incidental source of income which is to be diverted into some special fund, or where such governmental agency feels that in view of the rest of its tax system it is not forced to abstract every cent possible from the tax on inherited wealth, then the inheritance tax on the shares of the individual beneficiaries is certainly advisable; in so far as abstract justice is desirable or attainable in taxation, it is more fully embodied in the inheritance tax than in the estate duty. Where, however, a certain and large revenue is the primary element, the estate duty may be preferable; an estate duty can always be made to produce more than an inheritance tax unless the latter's rates are made relatively much severer. The injustice involved may be offset by the possibility that the additional revenue would otherwise have to be raised from other sources that are

[7] Richard T. Ely, *Studies in the Evolution of Industrial Society,* p. 292.

from a social point of view less desirous and more inequitable.

Finally, there should be noted the not unimportant detail of the greater administrative simplicity of the estate duty,—a factor not unimportant in influencing the Inheritance Tax Committee of the National Tax Association to recommend estate duties to the American states in place of their present inheritance taxes.

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A State Inheritance Tax Statute *

AN EXAMPLE of an inheritance tax statute (in part) follows:

72.01 *Subjects liable.* A tax shall be and is hereby imposed upon any transfer of property, real, personal or mixed, or any interest therein, or income therefrom in trust or otherwise, to any person, association or corporation, except county, town or municipal corporations within the state, for strictly county, town or municipal purposes, and corporations of this state organized under its laws or voluntary associations organized solely for religious, charitable or educational purposes, and to any national organization of veterans of the armed forces of the United States or subordinate unit thereof, which shall use the property so transferred exclusively for the purposes of their organization, within the state, in the following cases, except as hereinafter provided:

(1) WHILE A RESIDENT OF STATE. When the transfer is by will or by the intestate laws of this state from any person dying possessed of the property while a resident of the state.

(2) NONRESIDENT'S PROPERTY WITHIN THE STATE. When a transfer is by will or intestate law, of property within the state or within its jurisdiction and the decedent was a nonresident of the state at the time of his death.

(3) TRANSFERS IN CONTEMPLATION OF DEATH. When the transfer is of property, made by a resident or by a nonresident when such nonresident's property is within this state, or within its jurisdiction, by deed, grant, bargain, sale or gift, made in contemplation of the death of the grantor, vendor or donor, or intended to take effect in possession or enjoyment at or after such death. Every transfer by deed, grant, bargain, sale or gift, made within two years prior to the death of the grantor, vendor or donor, of a material part of his estate, or in the nature of a final disposition or distribution thereof, and without an adequate valuable con-

* Wisconsin Statutes, Chapter 72, Sections 72.01–72.04 (1945).

sideration, shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this section.

(4) TRANSFER BEFORE OR AFTER PASSAGE OF ACT. Such tax shall be imposed when any such person or corporation becomes beneficially entitled, in possession or expectancy, to any property or the income thereof, by any such transfer whether made before or after the passage of sections 72.01 to 72.24, inclusive; provided, that property or estates which have vested in such persons or corporations before this act shall take effect, shall not be subject to a tax; and provided further, that contingent interests created by the will of any person who died prior to the passage of this act shall not be taxed.

(5) TRANSFER UNDER POWER OF APPOINTMENT. Whenever any person or corporation shall exercise a power of appointment derived from any disposition of property, made either before or after the passage of sections 72.01 to 72.24, inclusive, such appointment, when made, shall be deemed a transfer taxable under the provisions of sections 72.01 to 72.24, inclusive, in the same manner as though the property to which such appointment relates belonged absolutely to the donee of such power, and had been bequeathed or devised by such donee by will; and whenever any person or corporation possessing such a power of appointment so derived shall omit or fail to exercise the same within the time provided therefor, in whole or in part, a transfer taxable under the provisions of sections 72.01 to 72.24, inclusive, shall be deemed to take place to the extent of such omission or failure, in the same manner as though the persons or corporations thereby becoming entitled to the possession or enjoyment of the property to which such power related had succeeded thereto by a will of the donee of the power failing to exercise such power, taking effect at the time of such omission or failure.

(6) JOINT INTERESTS. Whenever any property, real or personal, is held in the joint names of two or more persons, or as tenants by the entirety, or is deposited in banks or other institutions or depositaries in the joint names of two or more persons and payable to either or the survivor, upon the death of one of such persons the right of the surviving tenant by the entirety, joint tenant or joint tenants, person or persons, to the immediate ownership or possession and enjoyment of such property shall be deemed a transfer of one-half or other proper fraction thereof taxable under the provisions of this chapter in the same manner as though the property to which such transfer relates belonged to the tenants by the entirety, joint tenants or joint depositors as tenants in common, and had been bequeathed or devised to the surviving tenant by the entirety, joint tenant or joint tenants, person or persons, by such deceased tenant by the entirety, joint tenant or joint depositor, by will.

(7) INSURANCE PART OF ESTATE. (a) Insurance payable upon the death of any person in which any of the legal incidents of ownership remain in said person at the time of his death, except insurance returnable for income taxation, shall be deemed a part of his estate for the purpose of the tax, and shall be taxable to the person or persons entitled thereto, irrespective of the source of the premium payments. "Legal incidents of ownership" in a policy of insurance

as used herein mean the right of the insured or his estate to its economic benefits, the power to change the beneficiary, to surrender or cancel the policy, to assign it, to revoke an assignment, to pledge it for a loan, or to obtain from the insurer a loan against the surrender value of the policy.

(b) Insurance otherwise taxable under paragraph (a) of this subsection, to the clear value of ten thousand dollars payable to a beneficiary or beneficiaries other than the estate of the insured, shall not constitute a part of his estate for the purpose of the tax and shall be exempt from taxation. This exemption shall be in addition to all other exemptions and allowances, and each beneficiary of such insurance, other than the estate of the insured, shall be entitled to a portion of the total exemption based upon the ratio that the value of the insurance payable to him bears to the value of the total insurance payable to all such beneficiaries.

(8) BASIS OF TAX. The tax so imposed shall be upon the clear market value of such property at the rates hereinafter prescribed and only upon the excess of the exemptions hereinafter granted. Inheritance and estate taxes imposed by the government of the United States on property which is subject to the state inheritance tax, to the extent said federal taxes are computed on the value of the property for state inheritance tax purposes, shall be deemed debts and shall be deducted in determining the value of the property transferred.

(9) RECIPROCITY AS TO NONRESIDENT DECEDENTS. Personal property of a nonresident decedent made taxable under this chapter, except tangible personal property having an actual situs in this state, shall not be subject to the tax so imposed if a like exemption was allowed at the time of death of such decedent by the laws of the state, territory or district of the decedent's residence in favor of residents of this state, provided, that this section shall not apply unless a tax is imposed on the transfer of said property by the laws of the state, territory or district of residence.

72.02 *Primary rates, where not in excess of twenty-five thousand dollars.* When the property or any beneficial interest therein passes by any such transfer, where the amount of the property shall exceed in value the exemption specified in section 72.04, and shall not exceed in value twenty-five thousand dollars, the tax hereby imposed shall be:

(1) TWO PER CENTUM, WHERE. Where the person or persons entitled to any beneficial interest in such property shall be the husband, wife, lineal issue, lineal ancestor, brother or sister, or a descendant of a brother or sister of the decedent, a wife or widow of a son, or the husband of a daughter of the decedent, or any child legally adopted, or any child to whom such decedent for not less than 10 years prior to such transfer stood in the mutually acknowledged relation of a parent, provided, however, such relationship began at or before the child's fifteenth birthday, and was continuous for said 10 years thereafter, or any lineal issue of such adopted or mutually acknowledged child, at the rate of 2 per centum of the clear value of such interest in such property. The terms lineal issue, lineal ancestor, brother, sister, descendant, son and daughter shall include such relationship established through such legal adoption.

(3) SIX PER CENTUM, WHERE. Where the person or persons entitled to any beneficial interest in such property shall be the brother or sister of the father or mother or a descendant of a brother or sister of the father or mother of the decedent, at the rate of six per centum of the clear value of such interest in such property.

(4) EIGHT PER CENTUM, WHERE. Where the person or persons entitled to any beneficial interest in such property shall be in any other degree of collateral consanguinity than is hereinbefore stated, or shall be a stranger in blood to the decedent, or shall be a body politic or corporate, at the rate of eight per centum of the clear value of such interest in such property.

72.03 *Other rates, where in excess of twenty-five thousand dollars.* The foregoing rates in section 72.02 are for convenience termed the primary rates. When the amount of the clear value of such property or interest exceeds twenty-five thousand dollars, the rates of tax upon such excess shall be as follows:

(1) RATE WHERE AMOUNT TWENTY-FIVE THOUSAND DOLLARS TO FIFTY THOUSAND DOLLARS. Upon all in excess of twenty-five thousand dollars and up to fifty thousand dollars two times the primary rates.

(2) RATE WHERE AMOUNT FIFTY THOUSAND DOLLARS TO ONE HUNDRED THOUSAND DOLLARS. Upon all in excess of fifty thousand dollars and up to one hundred thousand dollars three times the primary rates.

(3) RATE WHERE AMOUNT ONE HUNDRED THOUSAND DOLLARS TO FIVE HUNDRED THOUSAND DOLLARS. Upon all in excess of one hundred thousand dollars and up to five hundred thousand dollars four times the primary rates.

(4) RATE WHERE AMOUNT OVER FIVE HUNDRED THOUSAND DOLLARS. Upon all in excess of five hundred thousand dollars five times the primary rates.

72.035 *Rate limit.* The tax imposed by section 72.02 and section 72.03 shall not exceed 15 per cent of the property transferred to any beneficiary.

72.04 *Exemptions.* The following exemptions from the tax, to be taken out of the first twenty-five thousand dollars, are hereby allowed:

(1) All property transferred to municipal corporations within the state for strictly county, town or municipal purposes, or to corporations of this state organized under its laws, solely for religious, humane, charitable or educational purposes, and to any national organization of veterans of the armed forces of the United States or subordinate unit thereof, which shall use the property so transferred exclusively for the purposes of their organization, within the state, and all property transferred to banks or trust companies of this state, or to individuals residing in this state, as trustees, in trust exclusively for public, religious, humane, charitable, educational or municipal purposes in this state, and all property transferred to the American National Red Cross or any chapter thereof, shall be exempt, including property heretofore transferred on which the tax has not been paid.

(1a) All property transferred to any corporation, organization, association or foundation of this state, in trust, and for the direct financial benefit of any town, city, school district, village or county of this state.

(2) Property of a clear value of \$15,000 transferred to the widow of the decedent, \$5,000 transferred to the husband of the decedent, and \$2,000 transferred to each of the other persons described in section 72.02 (1) shall be exempt. Any child of the decedent shall be entitled to credit for so much of the tax paid by the widow as applied to any of the same property which hereafter shall be transferred by or from such widow to such child, provided the widow does not survive said decedent to exceed 6 years, and provided, further, that where other property is also transferred by or from the widow to any such child, then such credit shall be applied only upon that portion of the total tax assessed against such child as is attributable to the property transferred upon which a tax was paid by the widow, such portion to be ascertained by the ratio that the property transferred upon which a tax was paid by the widow bears to the total amount of property transferred.

(4) Property of the clear value of two hundred and fifty dollars transferred to each of the persons described in subsection (3) of section 72.02 shall be exempt.

(5) Property of the clear value of one hundred dollars transferred to each of the persons described in subsection (4) of section 72.02 shall be exempt.

(6) No tax shall be imposed upon any tangible personal property of a resident decedent when such property is located without this state, and when the transfer of such property is subject to an inheritance or transfer tax in the state where located and which tax has actually been paid, provided such property is not without this state temporarily nor for the sole purpose of deposit or safe-keeping.

(7) Bequests not to exceed five hundred dollars for the care and maintenance of the burial lot of the deceased and bequests not to exceed five hundred dollars to the cemetery in which the said deceased is buried, and bequests not to exceed one thousand dollars for the performance of a religious purpose or religious service for or in behalf of the deceased or for or in behalf of any person named in his will, shall be exempt from any inheritance tax.

(8) Whenever part of an estate is within and part without the state, there shall be deducted for tax purposes only a proportion of the debts, expenses of burial and of administration, equal to the proportion which the property within the state bears to the entire estate, and any beneficiary shall be entitled only to a proportion of his Wisconsin exemption equal to the proportion which his interest in the property within the state bears to his entire interest in such estate.

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COMMITTEE ON INTERGOVERNMENTAL FISCAL RELATIONS

Intergovernmental Relations in the Death Tax Field: The Credit

WHERE the death tax is employed by a federal government and by its constituent states, as in the United States, a problem of overlapping revenue sources arises. Attempts at coordinating these overlapping taxes have been made in the United States, where the crediting device has developed as a unique institution. However, the crediting device is subject to limitations and imperfections. Aspects of federal-state relations in the death tax field were summarized by a Treasury-sponsored committee as follows: *

C. *Death and Gift Taxes*

Outstanding features of Federal and State death taxation as they affect intergovernmental relations are listed as follows:

1. The States were first in the field. However, the yield of the State tax is of relatively minor importance and is tending to become of even less importance in recent years.
2. A principal avenue of death-tax avoidance is through gifts made before death; the Federal Government and 12 States have attacked this problem through the enactment of gift taxes.
3. The principal device of coordination between Federal and State death taxes is the Federal credit.
4. Federal and State death taxes, owing in considerable part to weakness in coordination, which results in high Federal exemptions, are relatively much less productive than in Great Britain. (High Federal exemptions are supported on the ground that the States should cultivate the field of taxes on small estates; the States, however, do not do this very thoroughly.)
5. The State death tax has proved expensive and otherwise unsatisfactory as to administration. Legal and lay authority, State and local responsibility, are

* *Intergovernmental Fiscal Relations,* Vol. II, *Report: Summary* (Unpublished; Washington, D.C.: Treasury Department, 1943), pp. 92–96.

mixed in a variety of patterns. The units of government principally responsible for enforcement often have little if any financial stake in the results.

6. State death-tax revenues are highly concentrated in a few States. From 1936 to 1940, inclusive, New York, New Jersey, and Pennsylvania collected 49.4 percent of total State collections. Nine States collected 77.4 percent of the total.
7. State death-tax practice still shows much diversity despite the once-prevailing hope that the credit would lead to uniform practices. Thirty-eight States have designed their death tax structures to ensure full absorption of the credit allowed by the Federal Government. Seven base their taxes entirely on the Federal levy, while 31 supplement independent death taxes with a differential estate tax designed to absorb the 80 percent Federal credit.
8. Much multiple taxation (double domicile and double counting of intangibles) beclouds State death taxation.

Diversities of laws and conditions can be observed in the relation of State death taxes to Federal taxes by States. In New York the State tax from 1936 to 1939 came to only 28.7 percent of the Federal, but in the regions of least concentration of wealth, State collections were generally equal to, or in excess of, Federal revenues, running to 266.7 percent in Montana. The figures are accounted for in part by the fact that some of the assets of these States are absentee-owned and are part of estates of decedents domiciled elsewhere, thus appearing in the statistics as belonging to other States.

Federal and State death taxation is frequently cited as a field in which some coordination has already been achieved, particularly through a credit to the taxpayer against his Federal tax for death taxes paid the States. Inaugurated in the middle twenties, this device consists of an allowance up to 80 percent against the Federal tax as computed under the 1926 Federal estate-tax statute. The Federal law has since been amended several times, and the rates revised upward and the exemptions downward, but the credit is still tied to the antiquated 1926 law. The credit does not apply to the gift tax incorporated in the Federal law in 1932 and now a part of the inheritance-tax systems of 12 States. At the very least the credit should be adapted to the most recent estate-tax statute with applicability in terms of the present rates and exemptions, and to the taxation of gifts. Better still, the entire estate-tax system should be overhauled; Federal exemptions should be reduced to at least the average level of State exemptions (the present Federal exemption is $40,000 with an additional $40,000 for insurance not a part of the estate and made payable to named beneficiaries, and a separate $40,000 exemption in the gift tax); the estate and gift taxes should be integrated; and the crediting program should be brought into accord with current Federal practices. Going further, the credit should be broadened in an effort to eliminate dual administration and multiple taxation.

On strictly logical grounds a very strong case could be made for separation of sources as a coordination de-

vice in the death-tax field. If this were recommended, the Federal Government would be the choice as the taxing unit. The State tax is plagued by interstate competition and multiple taxation, and especially by the fact that estates are highly concentrated in a relatively few States, though the wealth represented may have been accumulated over a much wider area. On the other hand the States, with one exception, have a proprietary interest in this field and any proposal for surrender would rouse intense antagonism. The credit is now the accepted device for coordination in the field, and it can be remodeled to accomplish much wider objectives than contemplated in the original effort. Moreover, any method of "getting States out of the field" short of a Constitutional amendment would involve a distribution of revenues not very different from the present.

The credit has been fairly effective in the elimination of interstate competition, but it has largely failed to mitigate the conspicuous problems of dual administration, multiple taxation, and excessive diversity that characterize our overlapping system of death taxation.

In modernizing the credit, the law might be changed to allow the taxpayer a credit of 50 percent of the tax (at 1941 rates and assuming a $20,000 specific exemption) on the amount of the estate not exceeding $100,000, and a credit of 25 percent of the tax on the amount of the estate exceeding $100,000. This would enable the States to enact minimum estate-tax laws to cover their entire inheritance-tax schedule. Most of them would gain by such action in all brackets of the tax. (This is on the assumption that the Federal Government would also substantially reduce its exemptions.) Perhaps the greatest weakness of the present credit is that it requires dual administration. States are required to build up the taxpayer's liability to the State before the Federal credit is applicable. But the Federal Government could and should assume the task of determining the taxpayer's liability to the States. Or better still, this matter could be handled by joint administration. The only difficulty in this program, outside of the vested interests of Federal and State administrators, is the matter of State jurisdiction to tax. But this is a matter which the Federal Government ought to arbitrate in the interest of all concerned. The right to determine jurisdiction might well be imposed as a condition under which the Federal Government would offer its administrative services to the States. Going further, it might also be imposed as a condition for the credit itself.

State death taxation has long been harassed by dispute concerning the taxpayer's domicile, and the courts have failed or refused to assist in clearing the field of "double domicile." Other cases of multiple taxation, particularly in the taxation of intangibles, are fairly common and destined to become more so. The Supreme Court in recent decisions has shown an inclination to reject the role of arbitrator in these disputes. It is doubtful whether this multiple taxation is helpful to anyone, and it provides an indefensible penalty from the point of view of the cosmopolitan taxpayer. The Federal Government, through the use of persuasion sweetened with advantages it can offer the States, should seek to clear the field of these vicious anomalies. A liberal tax credit

could be used effectively toward this end.

It has long been recognized that in spite of some very stiff rates and occasionally onerous burdens imposed by the Federal estate-tax law, the results of the death-tax system are fiscally disappointing and its incidence highly capricious. For example, the owner of an estate of $100,000 can still make over 90 percent tax saving by disposing of half of his estate through *inter vivos* gifts. The death-tax field needs a thorough overhauling. What is needed is both integration and coordination plus the abandonment of excessive Federal exemptions. By integration is meant the taxation of gifts and transfers at death as a single cumulative base. If the job is done thoroughly, death taxes can be made to assume a place of prominence in the tax system commensurate with their inherent merits.

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COMMITTEE ON INTERGOVERNMENTAL FISCAL RELATIONS

Intergovernmental Relations in the Death Tax Field: Multiple Taxation

THE vexatious problem of territorial multiple taxation in the State death-tax field and the trend in the attitude of the Court on this subject is discussed in the following selection: *

(b) *Death Taxation*

In general, jurisdiction for the State death taxes has followed the rules for property taxation stated above. (Recent decisions of the Supreme Court have made it necessary to use the past tense in speaking of jurisdictional rules in this field.) In the case of intangibles left by a decedent, the State of the decedent's domicile has had the legal right-of-way in all but a few exceptional cases.

The problem of multiple taxation in the death-tax field is complicated by the plausible claims of competing jurisdictions. There is the claim, for instance, of the jurisdiction in which the heir as distinguished from the deceased, is domiciled. The claim appears to rest on strong grounds for the ability to pay is as much the heir's as the decedent's. However,

* *Federal, State, and Local Government Fiscal Relations,* pp. 235–238.

nowhere in this country and rarely abroad, has the State of the heir's domicile asserted any claim under the estate tax. The estate is administered in the State where the decedent is domiciled, and this State has been assumed to have exclusive rights, so far as such rights are based on domicile. Unincorporated real property is taxable where located. The State in which is situated incorporated real property, of which the absentee decedent's shares are representative, also has some logical claim to impose a death tax. Formerly such claims were freely asserted but they have now been quite thoroughly outlawed.[1] Judicial opinion on this matter was not unanimous; in a Wisconsin case [2] a minority opinion held that the corporation might, through its relationship as agent for its stockholders, bring the latter under the jurisdiction of the States in which the corporation did business. The dissent also laid stress on the fact that the corporation is only a legal fiction and that the stockholders could acquire a right to physical property by merely dissolving the corporation.

A strong claim on legal grounds can be asserted by the State in which the corporation, whose shares are involved in the transfer at death, obtained its charter. Until a few years ago it was quite common for the State of incorporation to tax nonresidents upon the full value of their shares in the corporation. In the important *First National Bank of Boston* v. *Maine* decision,[3] the Supreme Court ruled out all rights of the States to tax on the ground that they incorporated the company in which the decedent had shares. Such taxation was held to be contrary to the fourteenth amendment of the Federal Constitution under which the States may not deprive one of property without due process of law. A strong minority opinion held that the fourteenth amendment was being stretched beyond its legitimate application. Moreover, there were the interests of the debtor States to be considered. In a recent case, discussed below, the Boston bank decision was overruled.

Multiple taxation in the death-tax field also arises in cases of disputed domicile. This was brought sharply to the attention of the country in the notorious Dorrance case,[4] where both Pennsylvania and New Jersey, in addition to the Federal Government, succeeded in taxing the same intangible assets. The main element in establishing domicile is intent, and intent may be proved or disproved by a wide range of evidence, concerning the balance of which reasonable men and reasonable courts may differ. It seems logical, in cases of disputed domicile, to seek the arbitration of the United States Supreme Court, but the Court has rejected this role and has held that—

> uniformity in the decisions of the courts of different States as to the places of domicile, where the exertion of State power is dependent upon domicile within its boundaries—

is not required by the Constitution.[5] Efforts to implement the Supreme Court with the power to settle disputes of this character have proved

[1] *Beidler* v. *South Carolina Tax Commission* (282 U.S. 1 (1930)).
[2] *Estate of Shepard* (184 Wis. 88 (1924)).
[3] 284 U.S. 312 (1932).
[4] *Dorrance's Estate* (309 Pa. 151 (1932)); *In re Dorrance* (115 N.J. Eq. 268 (1934)); *Dorrance* v. *Pennsylvania* (287 U.S. 660 (1932)).
[5] *Worcester County Trust Co.* v. *Riley* (302 U.S. 292 (1937)).

abortive, and a move to induce States to adopt legislation referring disputed domicile cases to arbitration has as yet achieved no success.[6] It is very probable that double domicile cases, while conspicuous, and usually involving large estates, are quite rare, and the problem may have attracted more attention than it deserves. But no fair-minded individual can sanction this form of multiple taxation and it is quite clear that something should be done about the matter.

Great interest in jurisdiction to tax in the death-tax field attaches to the recent decision of the United States Supreme Court, overruling the Boston bank decision and upholding the right of Utah to tax the Union Pacific Co. stock of a nonresident decedent on the ground that the corporation had been given its charter by the taxing State.[7] This is an epoch-making decision and the divided opinions of the Justices contain so much illuminating discussion of the multiple-taxation problem that they are quoted here at considerable length.

Justice Douglas, speaking for the Court, stated that it was not unmindful of the view that judicial license for multiple taxation—

> disturbed the "good relations among the States" and had a "bad" practical effect which led many States "to avoid the evil by resort to reciprocal laws."

But in support of the determination to overrule the Boston Bank case he quoted the minority opinion in that case as follows:

> "We can have no assurance that the resort to the fourteenth amendment, as the ill-adapted instrument of such reform, will not create more difficulties and injustices than it will remove."

And he added:

> More basically, even though we believed that a different system should be designed to protect against multiple taxation, it is not our province to provide it.

In a concurring opinion Justice Frankfurter expressed the view that—

> each State of the Union has the same taxing power as an independent government, except insofar as that power has been curtailed by the Federal Constitution.

The limitations on State taxing power in the Constitution, dealing with the taxation of imports and exports, tonnage taxes, and discriminatory taxes on interstate commerce were reviewed, and it was concluded that—

> none of these limitations touches the power of a State to create corporations and the incidental power to tax opportunities which such State-created corporations afford.

To be sure—

> A State cannot tax a stranger for something it has not given him. When a State gives nothing in return for exacting a tax it may be said that there is no jurisdiction to tax.

But—

> modern enterprise often brings different parts of an organic commercial transaction wiithin the taxing power of more than one State, as well as of the Nation. It does so because the transaction in its entirety may receive the benefits of more than one government. And the exercise by the States of their constitutional power to tax may undoubtedly produce

[6] Bills embodying this plan have been introduced in the Delaware and New York legislatures. *Bulletin,* National Tax Association, April 1941, p. 210.

[7] *State Tax Commissioner of Utah* v. *Harkness* (10 U.S. Law Week, No. 421, 4341–4347, Apr. 28, 1942).

difficult political and fiscal problems. But they are inherent in the nature of our federalism and are part of its price. These difficulties are not peculiar to us. Kindred problems have troubled other constitutional federalisms. . . .

It may well be that the last word has not been said by the various devices now available through uniform and reciprocal legislation, through action by the States under the compact clause, article 1, section 10 (3), or through whatever other means statesmen may devise for distributing wisely the total national income for governmental purposes as between the States and the Nation.

In his dissenting opinion, Justice Jackson (Justice Roberts concurring) described the majority view as "a switch of abstract concepts" without adequate consideration of its "impact on the very practical and concrete problems of States and taxpayers." He added:

The older view ascribed a fictional consequence to the domicile of a natural person; it is overruled by ascribing a fictional consequence to the domicile of an artificial corporation. The reason back of the holding is this: Because Utah issued a charter to a corporation, which issued stock to a nonresident, which changed hands at his death, which required a transfer on the corporation's books, which transfer was permitted by Utah law, Utah got jurisdiction to tax succession to the stock. It is really as remote as that.

It appeared to Justice Jackson that any benefit derived by Union Pacific stockholders from Utah was negligible in proportion to the value Utah was being authorized to tax. Most of the value was derived from operation in interstate commerce—

a privilege which comes from the United States and one which Utah does not give or protect and could not deny.

The effect of the Court's decision, thought the Justice, would be—

to intensify the already unwholesome conflict and friction between the States of the Union in competitive exploitation of intangible property as a source of death duties.

Referring both to tax payment and tax-compliance burdens, he added:

The seriousness of these burdens is increased if the decedent owns stock in consolidated corporations incorporated in several States, and under this decision stocks of some consolidated railroads would be subject to tax on their full values by five or six States. One need not be unduly soft-hearted toward taxpayers to doubt whether the exhaustion of estates through multiplication of reports, returns, appraisals, litigation, counsel's fees, and expenses ultimately makes for a sound fiscal policy or enlightened social policy.

Justice Jackson referred to previous efforts at death-tax coordination as due to a—

premonition among the States that overlapping, capricious, and multiple taxation would lead to Federal occupation of the field.

He observed further that—

far-sighted States saw that the total revenue resources practically available to the States was not increased by overlapping their taxation and invading each other's domiciliary sources of taxation.

The Court's action, said Justice Jackson, leaves "doubts whether any legal limitations are hereafter to be recognized" in States' power to tax. The doctrine of benefit as a basis of taxation appeared to him impractical because in our interdependent society all States benefit all citizens. Expansion of the field of multiple taxation to other situations involving

intangibles and possibly even tangibles seemed likely although the Justice trusted that the Court did not mean to say that "might always makes right in taxation" and he predicted that some new boundaries of the power to tax would have to be drawn.

One commentator anticipated this decision with the observation:

The Court will no longer act as arbiter of the conflicting claims of the several States as long as those claims are reasonable. . . . Legislatures must face some of the difficulties that the courts have long shouldered for them.[8]

[8] Jesse V. Burkhead, "Double Taxation and Jurisdiction to Tax," *Bulletin*, National Tax Association, XXV, No. 9 (June 1940), 259–266.

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JOHN STUART MILL

Views on Economic and Social Effects of Inheritance and Its Taxation

IN HIS classic *Principles of Political Economy*, before the middle of the nineteenth century, Mill analyzed the role of inheritance among our economic institutions as follows: *

Section 3. Nothing is implied in property but the right of each to his (or her) own faculties, to what he can produce by them, and to whatever he can get for them in a fair market: together with his right to give this to any other person if he chooses, and the right of that other to receive and enjoy it.

It follows, therefore, that although the right of bequest, or gift after death, forms part of the idea of private property, the right of inheritance, as distinguished from bequest, does not. That the property of persons who have made no disposition of it during their lifetime, should pass first to their children, and failing them, to the nearest relations, may be a proper arrangement or not, but is no consequence of the principle of private property. Although there belong to the decision of such questions many considerations besides those of political economy, it is not foreign to the plan of this work to suggest, for the judgment of thinkers, the view of them which most recommends itself to the writer's mind.

No presumption in favour of ex-

* Vol. I, Book 2, Chap. 2, Secs. 3, 4, 5th ed.

isting ideas on this subject is to be derived from their antiquity. In early ages, the property of a deceased person passed to his children and nearest relatives by so natural and obvious an arrangement, that no other was likely to be even thought of in competition with it. In the first place, they were usually present on the spot: they were in possession, and if they had no other title, had that, so important in an early state of society, of first occupancy. Secondly, they were already, in a manner, joint owners of his property during his life. If the property was in land, it had generally been conferred by the State on a family rather than on an individual: if it consisted of cattle or moveable goods, it had probably been acquired, and was certainly protected and defended, by the united efforts of all members of the family who were of an age to work or fight. Exclusive individual property, in the modern sense, scarcely entered into the ideas of the time; and when the first magistrate of the association died, he really left nothing vacant but his own share in the division, which devolved on the member of the family who succeeded to his authority. To have disposed of the property otherwise, would have been to break up a little commonwealth, united by ideas, interest, and habits, and to cast them adrift on the world. These considerations, though rather felt than reasoned about, had so great an influence on the minds of mankind, as to create the idea of an inherent right in the children to the possessions of their ancestor; a right which it was not competent to himself to defeat. Bequest, in a primitive state of society, was seldom recognized; a clear proof, were there no other, that property was conceived in a manner totally different from the conception of it in the present time.[1]

But the feudal family, the last historical form of patriarchal life, has long perished, and the unit of society is not now the family or clan, composed of all the reputed descendants of a common ancestor, but the individuals; or at most a pair of individuals, with their unemancipated children. Property is now inherent in individuals, not in families: the children when grown up do not follow the occupations or fortunes of the parent: if they participate in the parent's pecuniary means it is at his or her pleasure, and not by a voice in the ownership and government of the whole, but generally by the exclusive enjoyment of a part; and in this country at least (except as far as entails or settlements are an obstacle) it is in the power of parents to disinherit even their children, and leave their fortune to strangers. More distant relatives are in general almost as completely detached from the family and its interests as if they were in no way connected with it. The only claim they are supposed to have on their richer relations, is to a preference, *ceteris paribus,* in good offices, and some aid in case of actual necessity.

So great a change in the constitution of society must make a considerable difference in the grounds on which the disposal of property by inheritance should rest. The reasons usually assigned by modern writers for giving the property of a person who dies intestate, to the children, or nearest relatives, are first, the supposition that in so disposing of it, the

[1] See, for admirable illustrations of this and many kindred points, Mr. Maine's profound work on Ancient Law in its relation to modern ideas.

law is more likely than in any other mode to do what the proprietor would have done, if he had done anything; and secondly, the hardship, to those who lived with their parents and partook in their opulence, of being cast down from the enjoyments of wealth into poverty and privation.

There is some force in both these arguments. The law ought, no doubt, to do for the children or dependents of an intestate, whatever it was the duty of the parent or protector to have done, so far as this can be known by any one besides himself. Since, however, the law cannot decide on individual claims, but must proceed by general rules, it is next to be considered what these rules should be.

We may first remark, that in regard to collateral relatives, it is not, unless on grounds personal to the particular individual, the duty of any one to make a pecuniary provision for them. No one now expects it, unless there happen to be no direct heirs; nor would it be expected even then, if the expectation were not created by the provisions of the law in case of intestacy. I see, therefore, no reason why collateral inheritance should exist at all. Mr. Bentham long ago proposed, and other high authorities have agreed in the opinion, that if there are no heirs either in the descending or in the ascending line, the property, in case of intestacy, should escheat to the State. With respect to the more remote degrees of collateral relationship, the point is not very likely to be disputed. Few will maintain that there is any good reason why the accumulations of some childless miser should on his death (as every now and then happens) go to enrich a distant relative who never saw him, who perhaps never knew himself to be related to him until there was something to be gained by it, and who had no moral claim upon him of any kind, more than the most entire stranger. But the reason of the case applies alike to all collaterals, even in the nearest degree. Collaterals have no real claims, but such as may be equally strong in the case of non-relatives; and in the one case as in the other, where valid claims exist, the proper mode of paying regard to them is by bequest.

The claims of children are of a different nature: they are real, and indefeasible. But even of these, I venture to think that the measure usually taken is an erroneous one: what is due to children is in some respects underrated, in others, as it appears to me, exaggerated. One of the most binding of all obligations, that of not bringing children into the world unless they can be maintained in comfort during childhood, and brought up with a likelihood of supporting themselves when of full age, is both disregarded in practice and made light of in theory in a manner disgraceful to human intelligence. On the other hand, when the parent possesses property, the claims of the children upon it seem to me to be the subject of an opposite error. Whatever fortune a parent may have inherited, or still more, may have acquired, I cannot admit that he owes to his children, merely because they are his children, to leave them rich, without the necessity of any exertion. I could not admit it, even if to be so left were always, and certainly, for the good of the children themselves. But this is in the highest degree uncertain. It depends on individual character. Without supposing extreme cases, it may be affirmed that

in a majority of instances the good not only of society but of the individuals would be better consulted by bequeathing to them a moderate, than a large provision. This, which is a common-place of moralists ancient and modern, is felt to be true by many intelligent parents, and would be acted upon much more frequently, if they did not allow themselves to consider less what really is, than what will be thought by others to be, advantageous to the children.

The duties of parents to their children are those which are indissolubly attached to the fact of causing the existence of a human being. The parent owes to society to endeavour to make the child a good and valuable member of it, and owes to the children to provide, so far as depends on him, such education, and such appliances and means, as will enable them to start with a fair chance of achieving by their own exertions a successful life. To this every child has a claim; and I cannot admit, that as a child he has a claim to more. There is a case in which these obligations light, without any extrinsic circumstances to disguise or confuse them: it is that of an illegitimate child. To such a child it is generally felt that there is due from the parent, the amount of provision for his welfare which will enable him to make his life on the whole a desirable one. I hold that to no child, merely as such, anything more is due, than what is admitted to be due to an illegitimate child: and that no child for whom thus much has been done, has, unless on the score of previously raised expectations, any grievance, if the remainder of the parent's fortune is devoted to public uses, or to the benefit of individuals on whom in the parent's opinion it is better bestowed.

In order to give the children that fair chance of a desirable existence, to which they are entitled, it is generally necessary that they should not be brought up from childhood in habits of luxury which they will not have the means of indulging in after-life. This, again, is a duty often flagrantly violated by possessors of terminable incomes, who have little property to leave. When the children of rich parents have lived, as it is natural they should do, in habits corresponding to the scale of expenditure in which the parents indulge, it is generally the duty of the parents to make a greater provision for them, than would suffice for children otherwise brought up. I say generally, because even here there is another side to the question. It is a proposition quite capable of being maintained, that to a strong nature which has to make its way against narrow circumstances, to have known early some of the feelings and experiences of wealth, is an advantage both in the formation of character and in the happiness of life. But allowing that children have a just ground of complaint, who have been brought up to require luxuries which they are not afterwards likely to obtain, and that their claim, therefore, is good to a provision bearing some relation to the mode of their bringing up; this, too, is a claim which is particularly liable to be stretched further than its reasons warrant. The case is exactly that of the younger children of the nobility and landed gentry, the bulk of whose fortune passes to the eldest son. The other sons, who are usually numerous, are brought up in the same habits of luxury as the future heir, and they receive, as a younger brother's portion, generally what the reason of the case dictates,

namely, enough to support, in the habits of life to which they are accustomed, themselves, but not a wife or children. It really is no grievance to any man, that for the means of marrying and of supporting a family, he has to depend on his own exertions.

A provision, then, such as is admitted to be reasonable in the case of illegitimate children, of younger children, wherever in short the justice of the case, and the real interests of the individuals and of society, are the only things considered, is, I conceive, all that parents owe to their children, and all, therefore, which the state owes to the children of those who die intestate. The surplus, if any, I hold that it may rightfully appropriate to the general purposes of the community. I would not, however, be supposed to recommend that parents should never do more for their children than what, merely as children, they have a moral right to. In some cases it is imperative, in many laudable, and in all allowable, to do much more. For this, however, the means are afforded by the liberty of bequest. It is due, not to the children but to the parents, that they should have the power of showing marks of affection, of requiting services and sacrifices, and of bestowing their wealth according to their own preferences, or their own judgment of fitness.

Section 4. Whether the power of bequest should itself be subject to limitation, is an ulterior question of great importance. Unlike inheritance *ab intestato,* bequest is one of the attributes of property: the ownership of a thing cannot be looked upon as complete without the power of bestowing it, at death or during life, at the owner's pleasure: and all the reasons, which recommend that private property should exist, recommend *pro tanto* this extension of it. But property is only a means to an end, not itself the end. Like all other proprietary rights, and even in a greater degree than most, the power of bequest may be so exercised as to conflict with the permanent interests of the human race. It does so, when, not content with bequeathing an estate to A, the testator prescribes that on A's death it shall pass to his eldest son, and to that son's son, and so on for ever. No doubt, persons have occasionally exerted themselves more strenuously to acquire a fortune from the hope of founding a family in perpetuity; but the mischiefs to society of such perpetuities outweigh the value of this incentive to exertion, and the incentives in the case of those who have the opportunity of making large fortunes are strong enough without it. A similar abuse of the power of bequest is committed when a person who does the meritorious act of leaving property for public uses, attempts to prescribe the details of its application in perpetuity; when in founding a place of education (for instance) he dictates, for ever, what doctrines shall be taught. It being impossible that any one should know what doctrines will be fit to be taught after he has been dead for centuries, the law ought not to give effect to such dispositions of property, unless subject to the perpetual revision (after a certain interval has elapsed) of a fitting authority.

These are obvious limitations. But even the simplest exercise of the right of bequest, that of determining the person to whom property shall pass immediately on the death of the testator, has always been reckoned among the privileges which might be

limited or varied, according to views of expediency. The limitations, hitherto, have been almost solely in favour of children. In England the right is in principle unlimited, almost the only impediment being that arising from a settlement by a former proprietor, in which case the holder for the time being cannot indeed bequeath his possessions, but only because there is nothing to bequeath, he having merely a life interest. By the Roman law, on which the civil legislation of the Continent of Europe is principally founded, bequest originally was not permitted at all, and even after it was introduced, a *legitima portio* was compulsorily reserved for each child; and such is still the law in some of the Continental nations. By the French law since the Revolution, the parent can only dispose by will, of a portion equal to the share of one child, each of the children taking an equal portion. This entail, as it may be called, of the bulk of every one's property upon the children collectively, seems to me as little defensible in principle as an entail in favour of one child, though it does not shock so directly the idea of justice. I cannot admit that parents should be compelled to leave to their children even that provision which, as children, I have contended that they have a moral claim to. Children may forfeit that claim by general unworthiness, or particular ill-conduct to the parents: they may have other resources or prospects: what has been previously done for them, in the way of education and advancement in life, may fully satisfy their moral claim; or others may have claims superior to theirs.

The extreme restriction of the power of bequest in French law, was adopted as a democratic expedient, to break down the custom of primogeniture, and counteract the tendency of inherited property to collect in large masses. I agree in thinking these objects eminently desirable; but the means used are not, I think, the most judicious. Were I framing a code of laws according to what seems to me best in itself, without regard to existing opinions and sentiments, I should prefer to restrict, not what any one might bequeath, but what any one should be permitted to acquire, by bequest or inheritance. Each person should have power to dispose by will of his or her whole property; but not to lavish it in enriching some one individual, beyond a certain maximum, which should be fixed sufficiently high to afford the means of comfortable independence. The inequalities of property which arise from unequal industry, frugality, perseverance, talents, and to a certain extent even opportunities, are inseparable from the principle of private property, and if we accept the principle, we must bear with these consequences of it: but I see nothing objectionable in fixing a limit to what any one may acquire by the mere favour of others, without any exercise of his faculties, and in requiring that if he desires any further accession of fortune, he shall work for it. I do not conceive that the degree of limitation which this would impose on the right of bequest, would be felt as a burthensome restraint by any testator who estimated a large fortune at its true value, that of the pleasures and advantages that can be purchased with it: on even the most extravagant estimate of which, it must be apparent to every one, that the difference to the happiness of the possessor between a moderate independence and

five times as much, is insignificant when weighed against the enjoyment that might be given, and the permanent benefits diffused, by some other disposal of the four-fifths. So long indeed as the opinion practically prevails, that the best thing which can be done for objects of affection is to heap on them to satiety those intrinsically worthless things on which large fortunes are mostly expended, there might be little use in enacting such a law, even if it were possible to get it passed, since if there were the inclination, there would generally be the power of evading it. The law would be unavailing unless the popular sentiment went energetically along with it; which (judging from the tenacious adherence of public opinion in France to the law of compulsory division) it would in some states of society and government be very likely to do, however much the contrary may be the fact in England and at the present time. If the restriction could be made practically effectual, the benefit would be great. Wealth which could no longer be employed in over-enriching a few, would either be devoted to objects of public usefulness, or if bestowed on individuals, would be distributed among a larger number. While those enormous fortunes which no one needs for any personal purpose but ostentation or improper power, would become much less numerous, there would be a great multiplication of persons in easy circumstances, with the advantages of leisure, and all the real enjoyments which wealth can give, except those of vanity; a class by whom the services which a nation having leisured classes is entitled to expect from them, either by their direct exertions or by the tone they give to the feelings and tastes of the public, would be rendered in a much more beneficial manner than at present. A large portion also of the accumulations of successful industry would probably be devoted to public uses, either by direct bequests to the State or by the endowment of institutions; as is already done very largely in the United States, where the ideas and practice in the matter of inheritance seem to be unusually rational and beneficial.[2]

[2] "Munificent bequests and donations for public purposes, whether charitable or educational, form a striking feature in the modern history of the United States, and especially of New England. Not only is it common for rich capitalists to leave by will a portion of their fortune towards the endowment of national institutions, but individuals during their lifetime make magnificent grants of money for the same objects. There is here no compulsory law for the equal partition of property among children, as in France, and on the other hand, no custom of entail or primogeniture, as in England, so that the affluent feel themselves at liberty to share their wealth between their kindred and the public; it being impossible to found a family, and parents having frequently the happiness of seeing all their children well provided for and independent long before their death. I have seen a list of bequests and donations made during the last thirty years for the benefit of religious, charitable, and literary institutions in the state of Massachusetts alone, and they amounted to no less a sum than six millions of dollars, or more than a million sterling." —Lyell's *Travels in America,* vol. i, p. 263.

In England, whoever leaves anything beyond trifling legacies for public or beneficent objects when he has any near relatives living, does so at the risk of being declared insane by a jury after his death, or at the least, of having the property wasted in a Chancery suit to set aside the will.

JOSIAH STAMP

The Economic Effects of Death Duties

THE economic effects of death taxes have always been a controversial matter. Particularly the effect of such taxes on saving and capital has long been warmly debated. Sir Josiah Stamp analyzed this problem as follows: *

One of the things most frequently urged against a tax is its effect in preventing the accumulation of capital, or in wasting capital. The Estate Duties have to meet such a criticism, and a little detailed examination may serve to indicate the line of approach to such a subject.

All taxation appears to affect capital accumulation, because if, *ceteris paribus,* it ceased to exist we should all have more either (1) to spend in consumption or (2) to save as capital. It is unlikely that (1) would monopolise the new fund, for even if it tended to do so the increased demand for consumable goods would in itself set up an increased demand for fixed capital to provide them. This net loss of saving capacity through taxation may be called "y." But, of course, all other things would *not* be equal, and the cessation of Government expenditure might so adversely affect the possibilities of effective saving, that accumulation of capital wealth would be actually retarded. A potent factor in successful accumulation and maintenance of capital is the setting aside of part of individual funds for collective use. This gain of saving capacity through Government expenditure may be called *"x."*

Hence we have the compulsory postulate at the outset that capital will be better situated by a certain definite sum being raised in taxation than if it were not raised, the net gain being $x - y$, a positive quantity. That definite sum having to be raised, the question is:

If part of the sum is raised by Death Duties, will it be less advantageous to capital wealth than if the whole sum were raised by other taxes? Do Death Duties (1) annihilate accumulated capital, or (2) prevent accumulation, and if so, do they do so more than other taxes?

I propose no inquiry into the value of *"x,"* but deal entirely with *"y"* to see if non-recourse to Death Duties will put *"y"* at a minimum, and therefore $(x - y)$, the capital gain, at a maximum. (Here it is necessary to point out that "Capital Gain," $x - y$, is not synonymous with *total national gain.* Even if one concludes that Death Duties ad-

* From *The Fundamental Principles of Taxation* (London: Macmillan & Company, Ltd., 1923), pp. 144–155. By permission of The Macmillan Company, publishers.

versely affect capital, and more so than other taxes, they may have other effects on national well-being which are fully worth it. Accumulation of savings is not the only important factor in well-being and the nation might easily save too much. I am not concerned with the wider inquiry.)

The first superficial observation when a payment out of an estate is made is that the capital value of that estate is reduced—the difference of capital has "gone." The reply that capital can only be embodied in material goods, and that these all remain the same, nothing having been burnt or destroyed, and that only a change in the title to use has taken place, so that the *National Capital* is unchanged, is only a little less superficial, and does not meet the point. For, of course—leaving the Government out of the question for the moment—there is at any given time a fund of immediate fluid savings offering itself for embodiment in fixed forms, and it is out of this that the estate duty payment comes. A pays the Government by selling land to B, who buys it by selling shares to C, who has not consumed all his income in the year current but was looking for an investment for the balance. If C had not bought the shares he would have supported a *new* investment, and, let us say, built a house. So even if no existing capital form is annihilated, we can at any rate say that a new capital form has been prevented from coming into being.

(But, of course, we cannot ignore the question as to what the Government does with the money. If it builds the house that C could not build, then the net effect on national capital is nil—there is merely a transfer from individual wealth or rights to collective wealth or rights, just as there would be if, wanting a building for offices, the Government took over, as its tax, the ownership of an existing building. But if the Government drops the money into the sea there is a net loss in national capital, and C's potential house is never erected; just as there would be if the Government burnt the building that it had taken over.)

In either case, therefore—destroying existing capital, or preventing accumulation of capital—we are concerned with Government action. Hence arises Plehn's warning that to regard death duty as current revenue and not to treat the yield as a permanent endowment for a specific purpose is an improvident proceeding, "inasmuch as the tax is drawn from accumulated capital and not from current income." It "would seem wise to use the income solely for buildings or improvements of an enduring character." But, of course, the *specific* application is not necessary—if the Government is spending in "permanent improvements" or objects of a capital nature the equivalent of the death duties it is as broad as it is long, and the other sources of revenue, which appear to be coming out of income and not capital, are assignable to non-permanent expenditure. No doubt opinions differ as to what constitutes capital expenditure, down from permanent military or naval works through battleships, to a completed land valuation, or a real but intangible organisation for National Insurance, but the two last mentioned would not appear in any ordinary computation of national capital, and, therefore, may reasonably be held to be no substitute in this con-

nection for the cotton mills that might otherwise have come into being. Gladstone held the view, prompted, I believe, by J. S. Mill, that death duties applied to the reduction of National Debt remained "capital" still. The community are in debt to A, and discharge the debt by buying War Loan with the death duty from B, who sells a house to pay the duty, A buying the house with the proceeds of the War Loan. A is in the same "capital" position as before, B is the loser by a house, and the community are the gainers by the liability discharged. This accords with the usual treatment of the National Debt in computations of national wealth.[1]

So much for the immediate effect of the transfer of wealth. There is annihilation of existing capital only in rare cases. There may be prevention of immediately potential capital if the Government has no equivalent capital expenditure.

But the last position is not peculiar to Death Duties. By our postulate the money has to be raised. If it is not paid by death duties on the wealthy, assume that it may be obtained as income tax on the middle class. The tax may then prevent them from saving what they were in the habit of doing, they may be pushed out of the new investment field and we may thus get an equivalent prevention of immediately potential capital. Or assume the revenue is obtained from the poor. If it does not come out of potential savings it must lessen consumption expenditure. This may or may not be efficiency-expenditure, but if it is, it reacts on productive capacity not only for the labourer himself, but reduces also the total industry-dividend, the share of the employer, and therefore the saving fund of the wealthy. *There is no proof that the immediate effect of taking revenue as death duty reduces immediately potential fixed capital more than an income tax which may equally trench upon potential savings.*

But the dynamic aspect over a series of years must now be considered in addition to the static position for a single year which is all we have so far treated.

Even if transferring wealth from individuals to the community does *not* affect the grand total at the moment, or even if there is little difference between transferring the house that a man has already saved (death duties) and the sterling that a number of people might just be going to invest (income tax), the knowledge that saved wealth will some day be transferred may powerfully affect the desire to save.

A completely confiscatory duty would almost stop most types of saving.

At one time it was thought that death duties would "tend to diminish the funds destined for the maintenance of productive labour," but that view is to my mind tainted with the "wages fund" fallacy. Mill considered the amount which would be derived by a high duty would be but a small proportion of the annual increase of capital in a wealthy country like ours, and its abstraction (and annihilation) would but make room for saving to an equivalent amount.[2] I agree with the first part of his view, but the second I think can only be assumed given certain conditions as to the rate of interest. It might be true in times of rising prices and

[1] *Vide* "The Wealth and Income of the Chief Powers." *S. J.* 1919 (S.).

[2] Mill, *Principles*, V. 2.

trade activity, but not in times of stagnation. Sidgwick thought that the bad effects are "not likely to be at all equal in proportion to the similar effect that would be produced by extra taxes on income, in fact, the limits of taxation on inheritances will be practically determined rather by the danger of evasion than by the danger of checking industry and thrift."

Bastable urges the same point, and considers, too, that the "equal amount of taxation would have to be imposed in other directions, and would in some degree trench on capital."

In the case of a mortgage on an estate raised to pay the duty, when the efforts of the owner to redeem it in fifteen years cause him to reduce expenditure, reduce wages and discharge servants, the result does not seem to differ essentially from what might follow an equivalent annual tax for fifteen years.

At the root of the whole matter lies the question: Will a man save less or more per annum if he has to pay a lump sum at death instead of an annual tax?

Now to the extent to which he himself turns the lump sum into an annual tax, by specific insurance provision, there is no difference. If he would have paid the income tax out of potential savings, out of consumption expenditure, or partly out of each, so equally may he be expected to bear the annual equivalent of the death duty. If this is widely done, death duties are not specially disadvantageous in their effect upon accumulating capital in comparison with an income tax.

Bastable regards the estate duty as a capitalised income tax, and many others have held this view. Seligman contests the point, but his objection, in my judgment, only amounts to showing that this cannot be used as a theoretical justification for the duty, because of the divergent rates of income tax that would result from the uncertainty of length of life. It does not alter the argument that if all persons pool their risks in insurance the tax may in fact be a general community income tax. But we have to recognise that to a considerable extent it is *not* turned into an income tax by the individual, and it is over this field of inquiry that most difficulty arises.

Apart from what the Government may do with the money, and from the individual point of view only, most writers seem to feel that the duty falls on accumulated wealth rather than on income, though admittedly the economic position of society and the habits of the people are important factors.

Professor Cannan has said: "Perhaps, on account of a certain obvious peculiarity of the time at which they occur, death duties discourage accumulation somewhat less than annual taxes, and consequently are rather more favourable to the non-propertied class. If they are graduated they necessarily tend to cause greater equality of wealth."

Now, it may be demonstrable that two burdens are actuarially alike, and yet the psychological appeal to the taxpayer may be very different. The bearing of this possibility upon this subject has not been really finally worked out and agreed, but Professor Pigou has recently treated it with some fulness.[3] He says: "*It has now to be observed that the check on the supply of waiting, brought about by the expectation of*

[3] Pigou, *Wealth and Welfare*, p. 374, etc.

death duties, is likely, ceteris paribus, to be considerably smaller than that due to the expectation of the former kind. Let us suppose that a million pounds has to be raised by taxation upon the fruits of industrial investment. It is indifferent to the State whether this annual sum is collected by a tax on the annual returns of all enterprises, or by a tax confined to the annual returns of enterprises that have been established for some time. The choice between the two methods is not, however, indifferent to the persons concerned in the enterprises. Since these persons discount future taxes precisely as they discount all future events, the expectation of taxes levied after the second method will have the smaller restrictive influence upon the quantity of waiting supplied by them. The fact that distance in time introduced a considerable chance that the investor may no longer be living when the postponed tax falls due, greatly emphasises this difference. Hence, there is a special and not generally recognised advantage in taxation by the method of a time limit. Delay in the levy enables the State to collect a given annual sum, in such wise that the expectation of the levy exercises a smaller restrictive influence upon the supply of waiting, and, hence, upon the magnitude of the national dividend, than would occur if the levy were immediate.

* * * *

The argument, however, is not yet exhausted. It has to be observed, further, *that the superiority of postponed, over immediate, taxes, is enhanced, when the levy is made, not after a distinctive time, during which there is a chance of the occurrence of the investor's death, but definitely at his death;* for, obviously, a certainty influences conduct more strongly than a probability. Furthermore, there are additional reasons why this form of postponed tax should impose a relatively small check upon the supply of waiting. In some measure the stimulus to accumulation consists in the hope of the distinction afforded by dying very rich. That stimulus is not interfered with by death duties."

Further points may be added to those put forward by Professor Pigou if we once admit that our income tax differentiates against savings-use in favour of consumption-use. People may be divided into two classes: (1) Those who are ambitious to die as rich as possible; (2) those who are indifferent to the actual sum left at death.

In the case of (1), as Mr. Carnegie has urged,[4] the death duties have no effect on saving. In the case of (2), prospective death duties may militate less against saving than equivalent income taxes, because there is always the *chance* of living to a good age, and being able to avoid death duties by division *inter vivos* at a late, but not too late, period, and a good many people may take this chance of "no tax at all," when no differentiation exists (for them) against savings-use. (But if many actually succeed, and realise their hope, then in order to maintain the total yield, the death duties rates must be *pro tanto* higher than the income tax rates.)

The whole fund of saved capital is a resultant of many different psychological forces, which do not answer in the same way to changes in conditions. The behaviour of those who are saving against risks or against be-

[4] Carnegie, *Problems of To-day.*

ing worse off, those who are saving to be better off, and those who save without effort or self sacrifice out of superfluity, will be very different. The net effect of all motives together cannot be finally determined. If taxes are paid out of pure economic (unearned) surpluses they have less tendency to shift effects to other factors of production and other social classes than if they are paid out of "earnings" (salary, interest, or profits) which have functional value in inducing full maintenance of the producing agent.

Despite these psychological considerations, however, on the whole, I think there may often be a tendency to curtail expenditure to meet an *annual* income tax, and to keep on saving and thus in the long run add more to capital than would be the case under the death duty regime. The very fact that the total annual yield is made up of a large number of comparatively *small* "doses," and that to each individual the payments are *regular*, must, I think, assist this tendency. In so far as this is true, death duties trench more upon the annual new investment fund and less upon the consumption expenditure than income taxes would do, but not to any marked extent. Of the £26,000,000 raised, a large part would be covered by insurance and have the same annual incidence as an income tax. Of the balance only a small part, probably not more than two millions, would be paid out of savings, where it might under an income tax have come out of consumption expenditure. This in relation to the total annual savings of about £350,000,000 is almost negligible. People greatly exaggerate this matter, because they forget that the money must be raised somehow; and *from the gross effect of the death duties on capital, they fail to take off the effect that other equivalent taxes would also have upon saving.*

(1) As a broad conclusion, therefore, apart from other economic effects of death duties, even current expenditure of the proceeds is likely to add to the nation's power of accumulation more than the actual *capital* it takes from individuals.

(2) *Immediate effect on realised savings.* (*a*) In so far as Government expenditure is in permanent works or reduction of debt there is only a transfer of capital. (*b*) If it is not so spent, savings may be "wasted," but if the money had been raised by other taxes, potential saving might have been "wasted" to just the same extent, and no special disadvantage attaches to death duties.

(3) *Ultimate effect on stimulus to saving.* Owing to powerful countervailing considerations the net effect is only slightly against the death duties as compared with other taxes. Reverting to the idea with which I opened, the death duties may leave "*y*" almost at a minimum. This is only an expression of personal views and no reliable body of received opinion exists.

BENJAMIN M. ANDERSON

Some Observations on Pending Tax Legislation in 1935

A POINT of view toward death taxes in sharp contrast to some of those previously expressed is expounded by Professor Benjamin Anderson as follows: *

Proposed Taxes a Menace to American Economic Life

The pending inheritance and income tax legislation at the rates provided in the House Bill, H.R. 8974, involves grave dangers for American economic life. It is not a question of misfortune for a few rich individuals. It is a matter of danger for the general economic situation, due to the forced bankruptcies of great estates or, short of bankruptcy, the disintegration and liquidation at forced sale of large estates. The legislation will precipitate situations in which changes in control of great industries will come at unexpected times, with undesirable changes in personnel and policy. We must reckon with the combination of the existing high Federal estate taxes, the existing State inheritance taxes, the proposed new Federal inheritance taxes, the existing State income taxes and the proposed increases in the already very high Federal income taxes in the higher brackets. This combination creates a total of exactions which are not merely, as the rates themselves would indicate, an approach to complete confiscation, but which would produce, in practice (when allowance is made for the expenses of administering the estate and for the shrinkage through liquidation) absolutely and definitely one hundred per cent dissipation of assets in the typical case of a very large estate.

If this new legislation passes, a man would be much better off inheriting as a single heir a $400,000 estate in Government bonds than he would be inheriting a $400,000,000 estate consisting of diversified assets, some liquid, some partially liquid, some real estate. In the former case he would be able to emerge with something like $280,000 worth of Government bonds, making no allowance for administrative expenses. In the latter case, he would go through several years of agonizing struggle in the effort to salvage something from the vast estate he had inherited, with the probabilities high that he would wind up with no assets, and with the possibility of a personal liability remaining to a

* Reprinted by permission from "Death Duties, Enterprise and the Growth of National Capital," *The Chase Economic Bulletin,* (New York: The Chase National Bank, Aug. 6, 1935), pp. 3–9; 10–13; 17–19.

bonding company for part of the inheritance tax to the Government. The rates would be so high even on a four million dollar estate that a man would do better to be the heir to $400,000 than to $4,000,000 in many cases, if the $4,000,000 represented primarily real estate received at a time when real estate had to be liquidated in a period of even moderately declining real estate values, or in a sluggish real estate market.

The economic consequences to the country of a situation of this sort can hardly be exaggerated. Crises and panics have more than once been touched off by the conspicuous bankruptcy of a sizeable house. The effect upon New York real estate values of the forced liquidation of real estate held in any one of several large estates would be very grave. But, apart from spectacular disasters of this character, the paralyzing effect in the long run upon the growth of capital in the country, and upon the willingness of men of fortune to undertake speculative ventures of the kind that develop new resources or that develop new ideas and new types of industry would be very grave.

The Morale of Business Enterprise

New ventures are not financed through the sale of securities to the public. Before public issues can be made successfully, the rule is that an enterprise must have established itself, must have an earning history, must have evidences of stability. The mortality among new ventures is high. Sometimes new ventures can be initially financed by men of small means and great enthusiasm who convince other men of small means that the thing is workable, and accumulate the necessary funds from numerous people, with relatively small amounts from each. But such new ventures are typically financed by men of sizeable fortunes. The small man cannot afford to put his all into one of these ventures. The hazard is too great. The man of wealth can afford to go into twenty such ventures, expecting to lose on most of them, but counting on two or three successful ones to make the whole twenty profitable.

If, however, a man with an estate of $4,000,000 must look forward to paying an estate tax of $1,296,000, followed immediately by his son's paying an inheritance tax of $1,130,000, he will be very little disposed, after he has passed fifty or fifty-five, to take the risk of tying up his fortune in illiquid form. Instead of going on during the years when his experience and his knowledge are at their best and his judgment is surest with respect to the profitable employment of capital, he will become timid and work for liquidity and try to put his estate into such a position that when he dies his son can still cling to something.

And the son, who should be working with his father during those years, in the kind of activities through which his father made the fortune, will, himself, under the influence of his father's attitude, in all too many cases, be turned into a timid, conservative person, concerned with holding what he has rather than with increasing it through new and profitable activities.

It is difficult to exaggerate the importance to the country of the motives and attitudes of the men who have the management and proprietary interest in the industries of the country. Leadership of economic ac-

tivity rests with a body of dynamic men, enterprisers, risk takers, planners, men fertile in new ideas and men quick in the appreciation and evaluation of new ideas. The profit motive and the desire for the accumulation of wealth are very powerful with these men. These are not their only motives. They desire also the approbation of their fellow men. They desire triumph in competition. They desire power. They find an immense satisfaction in achievement and in efficient work. They have the "instinct of workmanship." But these motives are found also among men who choose other careers than the business career, and the distinguishing motive of the business man, as compared with the man in certain of the less lucrative professions, is a much greater relative intensity of the profit motive. The scholar may express his personality in a book which he hopes will live. The creative business man expresses his personality in the development of a business which he hopes will live. And in order that the business may be created and may grow and live and may continue to express his personality, he must be able to acquire and to conserve economic resources. It is not necessarily profit for its own sake, but, in part at least, profit and wealth as instruments for carrying through his creative purposes.

The discouragement and even hopelessness that must face certain very conspicuous wealthy enterprisers, each with the whole of his vast estate in a single great business, if this legislation is adopted, has been a matter of public comment. But the proprietor of many a smaller enterprise, an enterprise which has represented his lifework, an enterprise into which he has put all his capital, an enterprise socially useful, imbued with his ideals and purposes, for the future management of which he has trained his sons, must shudder as he contemplates the virtual certainty, if this legislation is adopted, that not his sons and not his ideals and not his plans and purposes will dominate it after his death.

In conspicuous cases, well advertised in the headlines, sons of rich men and sons of men of substantial fortunes have had escapades which suggest that they may not be the best successors for their fathers in the conduct of great businesses. But the man who reaches his conclusions, not on the basis of the headlines, but rather on the basis of the study of the credit files of a great bank dealing with many business houses, including banks, reaches the conclusion, on the whole, that it is usually very well when a son, trained by an able father, succeeds that father as the owner of a business. Such sons do not have prominent places in the sensational headlines and do not get into the statistics based on such headlines. Such sons are not always chosen by their fathers as the active heads of the businesses. Sons-in-law, other kinsmen, or capable and trusted lieutenants of the father may be chosen in that capacity. But the son, as owner, tends to keep the continuity of organization and policy.

Family ties have weakened in the United States in the last generation, and family tradition and family pride are not so important with us as they once were. But the family is still a tremendously vital institution, with a vitally important social function, and is particularly significant from the standpoint of the keeping of the continuity of ideals, plans, purposes and organization in our

economic system. We should not ruthlessly destroy this family function.

The Limits of Desirable Death Duties

The present writer is not hostile to inheritance taxes and estate taxes as such. Rather, he has long been personally favorable to reasonable taxes of this kind, though holding that, to the extent that they are a tax on capital, the proceeds of the tax ought to be used by the State for capital purposes, including the reduction of public debt, rather than dissipated in operating expenditures. The present writer has shared the belief that vast fortunes involve undesirable political and social potentialities, and that public policy should be directed (a) toward making sure that such fortunes cannot be accumulated in anti-social ways, and (b) toward holding down the growth and the transmission of vast fortunes to the extent that this can be done without checking the accumulation of capital and the spirit of enterprise. The practical question is as to how far we can go without damaging the community in these matters.

The writer has studied the motives of men of large fortune and great enterprise. How far does concern for his children and his grandchildren and his great grandchildren constitute a stimulus which keeps a rich man of fifty, fifty-five or sixty active in business when he might instead retire and enjoy himself in spending money? There can be little question, I think, that concern for his children is a motive of vast importance, and that concern for his grandchildren already born is a motive of vast importance. Concern for his great grandchildren is more remote. It is there, but he would often be disposed to let them take their chances. I believe that inheritance taxes, without slowing down the activities of the creative business man, could be pushed far enough so that if a great fortune is to reach grandchildren and great grandchildren each generation must add very substantially to it by productive activity.

Estate and inheritance taxes graduated up to 50 per cent in the case of a great fortune, with administrative procedure such that the problem of liquidation is a manageable one, might not spoil the incentives of the founder of the fortune, though 50 per cent is, in my judgment, dangerously high. The top British rate has, for some years, been 50 per cent, with an additional one per cent inheritance tax or succession duty on direct heirs—the succession duty runs up to 10 per cent for bequests to strangers in England. That the combination of high estate taxes in England and high income taxes (the top bracket on the British income tax is 63.7 per cent) has operated to lessen British enterprise and to check capital accumulation is, in my judgment, hardly open to doubt. Certainly these high taxes have coincided with a period in which both capital accumulation and enterprise have been sharply slowed down in England.

It may be observed, with respect to England, that a much greater proportion of the British revenues come back to the people in the form of income on government securities and amortization of public debt than is true in the United States. There is, of course, waste and friction in the process of collecting taxes, and then disbursing them again in the form

of income to the people and replenishment of the capital market, but it would be very much worse, of course, if all the taxes collected in England were used for operating expenses and much worse still if, in addition to all the taxes, the government were adding heavily to debt in connection with current expenditures.

* * * *

Special Defects of Death Duties Intensified as Rates Rise

There are important objections to estate and inheritance taxes *per se* as compared with other forms of taxation. These objections are, in my judgment, offset by more important considerations when rates are reasonable, but they are increasingly important as rates rise.

(1) There is the objection of accidental and unequal incidence of the tax as between families where deaths come normally, spaced out generation to generation, and families where two or three deaths come in close succession.

(2) There is the objection that the amount of the tax depends upon the accident of the state of market values at the time of death. It was a very grave misfortune indeed for a family if the father died in New York State in the summer of 1929 with his fortune in stocks or in real estate or even in bonds, except Government bonds. Cases exist where nothing has been left for the heirs, in precisely that situation. An estate of a man who died in 1922, on the other hand, yielded more to the heirs when the administration was completed, despite the payment of inheritance taxes, than it was valued at at the time of his death.

(3) Inheritance and estate taxes at high rates are taxes on capital. If the tax is not unduly high, it can be paid in whole or in part out of income, and a great deal of inheritance tax discussion, which deals with rates far below those proposed or now in existence in the United States, objects to the notion that it is a tax on capital because in many cases it is paid in the course of a few years out of income. But with high rates it is a tax on capital. Very high inheritance and estate taxes necessarily involve liquidation and commonly involve a sacrifice in values—to the advantage of speculators on the lookout for bargains, but not to the social advantage. Such a tax does not, of course, involve the destruction of existing physical capital in the form of plant and equipment. But it does draw into the Treasury the liquid capital of those who purchase the liquidated property—liquid capital which would otherwise be invested in creating new physical capital. Such a liquidation involves disruption of organization and shifting of management and control in businesses.

Wastes in Forced Liquidation

One able tax lawyer estimates that one should regularly count on a 15 per cent loss if an estate has to be liquidated. Experience of others would suggest different figures. The character and composition of the estate makes an enormous difference. If it is in Government bonds and other highly liquid assets, including stocks having a wide and active market, there need not be loss, but if it is in a business, or if it is in a far-flung assortment of business ventures, particularly of the pioneering sort—the kind of business which has been most useful in making the progress of the country—liquidation losses would ordinarily be heavy.

How great these liquidation losses can be will be recognized, I think, when it is considered that the 20 per cent maximum Federal estate tax existing in 1929 was sufficiently high to wipe out the whole value of certain estates whose owners died in 1929, so that the estates had to be liquidated in the depression years that followed. The rules regarding valuation do not provide adequate leeway to give any assurance that liquidation will not wipe out the small remainder after these very high taxes are imposed. For the purposes of the Federal estate tax, valuation is unqualifiedly fixed as of the date of the decedent's death. For New York State tax purposes, the same rule holds. The proposed additional Federal inheritance tax offers a mitigation which might, in certain cases, be helpful, in that, while it takes the initial valuation as of the date of the decedent's death, it allows for the depreciation which takes place within the following year. But the largest tax of all is, of course, the Federal estate tax. It is, moreover, improbable, in the case of large estates, that administration can be completed within a year, and there is no protection against depreciation taking place after the first year.

Moreover, valuation is one thing and realizing the valuation in the actual liquidation process is another thing. The market value rule in the case of securities, for example, reasonable enough in the case of moderate holdings of active securities, is a very unsafe guide in the case of large holdings of relatively inactive securities. Usually these simply cannot be liquidated at the prevailing market price. Nor can the appraised value of real estate be realized at a forced or hurried sale. The dangers of complete annihilation of an estate by forced liquidation grow increasingly great as the tax rates rise and the theoretical percentage left after taxation is reduced. In the case of estates where only 15 per cent is left, which is true of those above thirty-five million dollars with one heir, the probability is high that the typical estate would be completely dissipated. This is on the basis of liquidation wastes only, and omits consideration of costs of administration.

* * * *

Capital Accumulation and Social Progress

It has, until recently, been virtually axiomatic among economists, except Socialist writers, that the growth of capital through the investment of income in productive enterprises rather than its expenditure for current consumption is a mainspring of economic progress and a primary cause of rising wage rates and rising standard of life for the masses of the people. When capital and natural resources are abundant and men are scarce, wages are high. There are those who question this doctrine today, holding that "oversaving" is a cause of crisis and depression, and that men of large fortune oversave. The same doctrine attacks the growth of corporate surpluses through the ploughing back into the business of part of the profits of the business—the process by which the great Ford industry was built up.

I have no doubt at all that the orthodox doctrine is true, and that capital growing out of true savings is socially beneficial, has not been overdone and cannot be overdone. The trouble comes when rapidly expanding bank credit is made a substitute

for true savings. I recognize five main sources of capital, the first four of which are wholesome, while the fifth can be wholesome if not overworked. They are: (1) individual thrift, through the investment of part of income in productive enterprise, or by putting it in the savings bank or other financial institution, so that these institutions may put it at the service of those who are engaged in productive enterprise; (2) business thrift, including very especially corporate thrift, manifesting itself in the growth of surplus on the liability side of the balance sheet, and in the increase of productive equipment and plant and working capital on the asset side of the balance sheet; (3) taxation for capital purposes, as when a governing body uses part of the proceeds of its taxes in reducing public debt or when it builds needed public works out of the proceeds of taxation; (4) direct capitalization, primarily important in agriculture. This comes when the farmer uses his spare time in building barns and fences or when the farmer lets his flocks and herds increase instead of selling off the annual increase, or when the farmer turns his wheat land into orchard, etc.

These four sources of capital are sound and wholesome, and no country has ever gone wrong through engaging in them. The trouble comes with the fifth source of capital, namely, (5) an expansion of bank credit, the proceeds of which are used for capital purposes. Held within limits, this is a useful and necessary part of the process, particularly as anticipating the formation of capital through the other four ways and as easing off friction and tension in putting new ventures through and in marketing operations in connection with new securities. But this source of capital was so terribly overdone in the period from 1922 to 1929, particularly by stimulating the vast speculative rise in securities and real estate, that a misinterpretation of it has given a great deal of currency to the fallacy of "oversaving." In 1927 and 1928, for example, the percentage of all "income" reported for taxation to the Federal Government, growing out of profits on stocks, bonds and real estate, ran something like 11 per cent, and this form of "income" was probably the least completely reported form of income. To the extent that these profits were "saved" and "invested," a spurious and fictitious element was brought into the picture. Virtually everything in finance became unwholesome under the impetus of the gigantic expansion of bank credit from 1922 to 1929. But the remedy for this sort of thing does not lie in confiscatory taxes on large incomes and large inheritances, but rather in sound Federal Reserve Bank policy.[1]

[1] See *Chase Economic Bulletin,* VI, No. 3; VII, No. 4; VIII, Nos. 1 and 2; IX, Nos. 1 and 3; X, No. 3. See also the writer's testimony in the Senate Hearings on "The Banking Act of 1935," pages 435–497.

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GEORGE T. ALTMAN

Integration of the Estate and Gift Taxes

A LONG-STANDING means of avoiding death taxes has been through the disposition of property by gift. Legislators have sought to prevent this avoidance by the enactment of gift taxes. However, these latter taxes have proved only partly effective in accomplishing their objective. Currently it is proposed that levies on life and death transfers be combined into a single tax. This is the subject of the following selection: *

To give, yet not to give—that is the problem which fear of death taxes has forced down the throats of prospective decedents. Substitutes for testamentary disposition in a hundred different forms have been the nemesis of legislators and tax administrators as far back as death taxes have been levied. A person may desire to leave as much property as possible to his children, and to that end to diminish as far as possible the death taxes that will be imposed; nevertheless, as long as he lives he will want to keep the property for his benefit or at least under his control. Ground between these two desires, decedents have invented all manner of disposition *inter vivos* in which they have attempted to retain control. Often in their eagerness to avoid the death taxes they have added a provision destroying the control which under another provision they essayed to retain, thereby attempting to fool the tax gatherer but in result fooling only themselves, or rather their heirs.

For example, beginning with the 1924 Act the federal estate tax law has contained a specific provision including in the gross estate property transferred subject to a power of revocation, whether the power was exercisable by the decedent alone or in conjunction with any other person; and the Supreme Court had occasion to decide that this provision was applicable and valid even where such other person was the beneficiary.[1] Obviously, a power of revocation exercisable only with the consent of the beneficiary is no power at all. Its inclusion in a trust instrument is but evidence of the absurd lengths to which persons will go in the attempt to avoid death taxes and at the same time retain until death the power and benefit which ownership has meant to them.

[1] Helvering *v.* City Bank Farmers Trust Co., 296 U.S. 85 (1935).

* Reprinted by permission from *Law and Contemporary Problems,* VII, No. 2 (Duke University School of Law, Durham, N.C., Spring 1940), 331–335.

That Congress was aware of the use of testamentary substitutes is shown by the fact that in the very first federal estate tax act, that enacted in 1916, it provided for inclusion in the gross estate of transfers made in contemplation of death, and of transfers *inter vivos* intended to take effect in possession or enjoyment at or after death. But Congress was soon to find that testamentary substitutes were of many kinds, and that when one fell under its ax there was always another to take its place. In 1924 it added inclusion of transfers subject to a power of revocation whether the power was exercisable by the decedent alone or in conjunction with any other person. In 1926 it made conclusive with respect to transfers over $5,000 to any one person, the presumption contained in earlier acts that transfers made within two years of death were made in contemplation of death; but the Supreme Court ruled this conclusive presumption out as violative of due process.[2] In 1931 the Supreme Court emasculated the provision requiring inclusion in the gross estate of transfers intended to take effect at or after death by holding that it did not apply to irrevocable transfers though the income was reserved by the grantor for life.[3] In consequence Congress added a provision expressly including such transfers in the gross estate. In 1936 the provision with respect to revocable transfers underwent similar elaboration. The Supreme Court indicated that a power to alter, amend or revoke might not include a power to terminate,[4] and so Congress added the word "terminate." The Supreme Court further held that such a power included only a power exercisable by the decedent as settlor, not one exercisable by him as trustee,[5] so that Congress had to add the words, "in whatever capacity exercisable." Again, the Supreme Court opined that the act did not cover a power not reserved in the trust instrument but arising thereafter, as where a trustee resigned and the decedent was elected in his place by the remaining trustees; [6] as a result, Congress added the words, "without regard to when or from what source the decedent acquired such power." Like the heads of the hydra, every time one form of testamentary substitute fell beneath the Congressional knife, there were two others to take its place. Were it not for the recent action of the Supreme Court in holding that the transfer of property subject to reverter on the predecease of the grantee was one intended to take effect in possession or enjoyment at or after the grantor's death,[7] Congress might now be lunging at another hydra head.

Because of this hopeless battle with testamentary substitutes Congress imposed the gift tax, a tax on pure gifts *inter vivos,* as a fortifying complement to the estate tax. It was first imposed under the Revenue Act of 1924, repealed in the Revenue Act of 1926, and then restored under the Revenue Act of 1932. Since then it has been continuously in force, the rates being approximately 75% of those imposed by the estate tax.[8] The

[2] Heiner *v.* Donnan, 285 U.S. 312 (1932).

[3] Burnet *v.* Northern Trust Co., 283 U.S. 782 (1931).

[4] Helvering *v.* Helmholz, 296 U.S. 93 (1935).

[5] White *v.* Poor, 296 U.S. 98 (1935).

[6] White *v.* Poor, *supra* note 6.

[7] Helvering *v.* Hallock, 60 Sup. Ct. 444 (1940), overruling Helvering *v.* St. Louis Union Trust Co., 296 U.S. 39 (1935), and Becker *v.* St. Louis Union Trust Co., 296 U.S. 48 (1935).

[8] Actually, because the estate tax is im-

states, which like the federal government have had to endure the battle with testamentary substitutes, have begun to follow the federal government in the adoption of gift taxes. So far gift taxes have made their appearance in Oregon, Wisconsin, Virginia, Colorado, Minnesota, North Carolina, Tennessee and California.

The federal gift tax, and those of several of the states, are cumulative, that is, the rate brackets applicable to the gifts made in any year are determined by setting such gifts on top of the aggregate of gifts made in prior years since the start of the continuous imposition of the tax.[9] Thus, in effect, the gifts made throughout the various years are treated as if made at one time. By this method there is prevented avoidance of the gift tax by a spread of gifts over many years, and thereby the gift tax, with respect to gifts *inter vivos,* is given all of the efficacy of the estate tax. Even so, the gift tax falls far short of the mark, for the grantor can, by evenly dividing his gifts between gifts *inter vivos* and transfers at death, bring his transfers down into much lower brackets than would be applicable if he made all of his transfers either as gifts *inter vivos* or as transfers at death.[10] It is the same result as that accomplished under the income tax by dividing the income equally between husband and wife. As a result, the prospective decedent still has the problem of making transfers *inter vivos* without wholly removing his fingers from the property transferred, and yet without leaving it within the reach of death taxes.

The suggestion is almost immediate that the gift tax and death tax be combined into a single cumulative transfer tax. The scheme of the federal gift tax could be used, with the transfers in the year of death, both *inter vivos* and at death, regarded as the final transfers. The rate brackets applicable to the year of death would be determined, as under the present federal gift tax, by superimposing the transfers made in that year, both *inter vivos* and at death, upon the aggregate of transfers made in prior years.

Validity of such a scheme of transfer tax, combining pure gifts *inter vivos* with transfers at death under one tax, is now clear.[11] Moreover, if such a tax is enacted, there is nothing to prevent inclusion of gifts made prior to the date of enactment in determining the rate brackets applicable to transfers made after the date of enactment. It has been held, for example, that property otherwise beyond the reach of a state inheritance tax because beyond the borders of the taxing state could be included for the purpose of determining the

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posed on the entire estate without deducting the tax, while the gift tax is imposed on the amount actually passing to the donees, the rates of the latter tax are less than 75% of the former. Thus, for an estate of $10,040,000 the gift tax is about 50% of the estate tax. Montgomery, *Federal Taxes on Estates, Trusts and Gifts, 1938–39,* pp. 370–371.

[9] This feature was not present in the federal gift tax adopted in 1924.

[10] It is possible to calculate the respective portions of an estate which should be given away during the owner's life and retained until his death in order to produce the minimum combined gift and estate tax. For a table illustrating these proportions for estates of various sizes, see Montgomery, *Federal Taxes on Estates, Trusts and Gifts, 1938–39,* p. 427. In an estate of $5,000,000, the minimum rate is reached when the owner retains $640,000. The minimum combined rate is then 19.5% as against the estate tax rate on the entire estate of 38%. *Id.* p. 426.

[11] Helvering *v.* Bullard, 303 U.S. 297 (1938).

rate,[12] and likewise that stores otherwise beyond the reach of a chain store tax because beyond the borders of the taxing state could be included for the purpose of determining the rate.[13] It should follow that transfers otherwise beyond the reach of the taxing act because made before enactment of the act could be included for the purpose of determining the rate brackets applicable to transfers made after enactment of the act. From the standpoint of practical administration, however, the gifts to be included for this purpose could include only those made since the enactment of the gift tax. Discovery of gifts made prior to that time would be impracticable. Considering both validity and practical administration, then, the gifts to be included for the purpose of determining the rate brackets applicable under such a combined gift and estate tax could include the gifts made in prior years from the beginning of the continuous imposition of the gift tax which, together with the estate tax, it supersedes.

For example, suppose Congress enacted such a tax applicable to decedents dying after December 31, 1940, and that a certain decedent died December 1, 1941. Suppose further that the schedule of rates under the new transfer tax was the same as the schedule of rates under the present federal gift tax law, and that the other provisions of the present gift tax law were also embodied in the new law. Suppose also that this particular decedent had made gifts in prior years totaling, after deducting the $4,000 exclusion applicable to each donee in any one year ($5,000 with respect to gifts made before 1939), and after deducting gifts to charities, and so forth, but before deducting the so-called specific exemption of $40,000—totaling, with these deductions, $400,000. Now suppose that in 1941 he made gifts totaling, with similar deductions, $200,000 up to the date of death, and $400,000 in transfers at death. His transfer tax for the year of death would be computed as follows:

Transfers at death	$ 400,000	
Gifts *inter vivos* in 1941, the year of death	200,000	
Total transfers in year of death	$ 600,000	
Transfers in prior years	400,000	
Total transfers	$1,000,000	
Deduct specific exemption	40,000	
Net transfers	$ 960,000	
Tax on this amount under schedule adopted		$158,250
Deduct		
Tax under same schedule on total of gifts made in prior years:		
Total of gifts made in prior years	$ 400,000	
Less specific exemption	40,000	
Net gifts made in prior years	360,000	
Tax as computed under same schedule		43,950
Tax payable on transfers in year of death		$114,300

12 Maxwell *v.* Bugbee, 250 U.S. 525 (1919).

13 Great Atlantic & Pacific Tea Co. *v.* Grosjean, 301 U.S. 412 (1937).

The same integrating scheme could be applied, with slight variation, to the state gift and inheritance taxes, the rates of which vary according to the relation of the donee or legatee to the donor or decedent. Under this scheme it is obvious that a prospective decedent would have nothing to gain, as far as taxes on gifts and transfers at death are concerned, by making gifts during his lifetime. It might, in fact, be said that he would tend to defer gifts in order to defer the payment of the taxes and thereby to save the interest for the period of deferment on the amount of taxes involved. This tendency could be counteracted by allowance of a credit against the tax payable for the final year, of an amount computed like interest, at say 3 or 4%, on the taxes paid for prior years from the dates of payment to the date of death. The saving, however, that gifts *inter vivos* ordinarily effect in income taxes, by dividing the income-producing capital and thus bringing the donor's income down into lower brackets, might be expected to counteract any tendency to defer gifts merely to save the interest on the tax amounts for the period of deferment. Perhaps, then, any credit against the final tax on account of such interest lost where transfer taxes have been paid in prior years might be disregarded.

In any case, it is obvious that with replacement of the separate gift and death taxes by a single transfer tax the reason for all testamentary substitutes, at least as far as taxes are concerned, will have disappeared. Transfers in contemplation of death, transfers to take effect in possession or enjoyment at or after death, and transfers with a power reserved, in all of their motley forms, with all of their gossamer distinctions, that have fed for a generation the fires of battle between tax lawyers on the one hand and tax administrators and legislative bodies on the other, that have evoked from the courts a type of reasoning reminiscent of the seminars of the middle ages, that have kept the fingers of prospective decedents quivering with the faint caress of property transferred but still theirs, yet not theirs—all these will vanish when the separation between the gift and death taxes is borne to its final resting place.

WILLARD C. MILLS III

Transfers from Life Tenant to Remainderman

THE death tax, perhaps more than any other, is plagued by loopholes which have seriously impaired the effectiveness of the tax. Some of these loopholes are discussed in the selection that follows: *

The basic assumptions upon which the ideas herein advanced rest are, first, that the present federal estate tax should be protected as a source of revenue, since it is one of the few taxes the burden of which bears less heavily upon the poor than upon the rich; and, second, that in order to protect the estate tax as a source of revenue, the transfer from one generation to the next of the right to enjoy property should be taxed with as little regard as is feasible to technical legal distinctions as to the nature of the transfer.

Statement of the Problem

Under the present federal estate tax a transfer of property in full ownership from a father to his son is taxable; and a subsequent transfer of the property in full ownership from the son to his son is also taxable; but where the transfer from the father consists of the giving of a life estate to his son and the remainder to the grandson, no tax is imposed upon the transfer from the life tenant son to the remainderman grandson. In the second case, although there has been a transmission of wealth from one generation to the next, no tax is imposed.[1]

Logical Basis for Not Taxing Transfers from Life Tenant to Remainderman under the Estate Tax

There is a basis in logic for not taxing transfers from life tenant to remainderman under the estate tax. The applicability of the federal estate tax is limited, with certain exceptions, to the transfer of property over which the decedent had a power of disposition at the time of his death.[2] Even as extended by the ex-

[1] I. R. C., Sec. 811, reads as follows: "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property . . . to the extent of the interest therein of the decedent at the time of his death." In the example given above there is a cesser of the life tenant's interest at his death. The extent of the life tenant's interest at death being zero, no federal estate tax is due.

[2] The following types of property are included in the estate tax base, despite the fact that the decedent has no control over the disposition of such property at the time of his death: gifts made in contemplation of death; gifts intended to take effect in possession or enjoyment at or after death; the dower, curtesy, or equivalent interest of the surviving spouse; the decedent's interest in

* Reprinted by permission from *Taxes—The Tax Magazine*, XIX, No. 4 (April, 1941), 195–197, 238.

ceptions, the estate tax applies only to the transfer of property over which the decedent either held or could have acquired the power of disposition at sometime during his life. The exemption of transfers from life tenant to remainderman is quite logical, therefore, since at common law a life tenant without power of appointment cannot acquire control of the disposition of the property in which he enjoys a life tenancy.

However, if it be found that the failure to tax transfers from life tenant to remainderman is against well-settled public policy, and if it be further found that this failure bids fair to completely emasculate the estate tax, then there is need for quickly casting off this tyranny of narrow logic.

Failure to Tax Transfers from Life Tenant to Remainderman in Relation to Public Property

The rule against perpetuities is an expression of the compromise effected by the common law courts between, on the one hand, the desire of men of wealth to dictate the usage of their property for as long after death as possible, and, on the other, the public need that the power freely to sell or otherwise dispose of property be ever present in a living person. Suspension of the power to sell or otherwise dispose of property has for so long been so clearly regarded as against public interest that the rule against perpetuities, restricting such suspension, has become a universally accepted principal of common law.

The estate tax, through its failure to tax transfers from life tenant to remainderman, encourages suspension of the power to sell or otherwise dispose of property for as long as possible. Thus, the failure to tax transfers from life tenant to remainderman works directly against the sound public policy that finds judicial expression in the rule against perpetuities.

Failure to Tax Transfers from Life Tenant to Remainderman in Relation to Tax Avoidance

As long ago as 1926 it was estimated that a full one-quarter of inherited property was being transferred by way of life estates with remainders-over.[3] Today, under the pressure of a much heavier estate tax, the use of property settlements as a means of avoiding the estate tax is no doubt even more widespread.

By settling his property in the form of life estates with remainders-over a man of wealth may provide a period of upward of 100 years during which numerous transfers of the property may be made free from liability to the federal estate tax. Indeed a Delaware statute makes it possible for residents of that state to avoid the federal estate tax forever.[4]

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property held by the decedent and spouse as tenants by the entirety or in property held by the decedent and others as joint tenants; and, it is contended, proceeds of life insurance policies taken out by the decedent upon his own life even though the decedent had irrevocably named a beneficiary other than his estate prior to his death (*Chase National Bank* v. *U.S.*, 28 F. Supp. 947, 39-2 USTC ¶9653 (S.D.N.Y., 1939)). Also to be included in the estate tax base are inter vivos gifts, enjoyment of which is subject at the date of the decedent's death to any change through exercise by the decedent of a power to alter, amend, revoke or terminate, and transfers with respect to which the decedent's power to change the disposition is exercisable only with the consent of a beneficiary.

[3] Shultz, W. J., *The Taxation of Inheritance*, p. 231.

[4] Del. Laws 1933, c. 198. See Leach, "Per-

The significance of this failure to tax transfers from life tenant to remainderman is not as yet fully realized because of the fact that *the estate tax does apply to the transfer from the settlor to the first life tenant.* Transfers under settlements created to avoid the high rates introduced by the Revenue Act of 1932 have been of this initial *taxable* type.

The disease is now in its quiescent stage. In a few years, as transfers from the initial life tenant to subsequent life tenants become more prevalent, the ravages wrought by our present negligence will become only too apparent. It can be predicted with confidence that, unless transfers from life tenant to remainderman are taxed, the base of the estate tax will continue to shrink to the point where the tax will no longer be worth its keep.

Any attempt to remedy the situation a few years hence will require the bludgeon of retroactive change. That is, once having found the estate tax suffering with a bad case of pernicious anemia brought on by the blood-letting of property settlements, the Congress would then be forced to subject transfers under *past* settlements to the tax as well as transfers under future settlements. At such a late date a non-retroactive extension of the tax would be both inequitable and inadequate. Retroactivity would wreak havoc upon the well laid plans of the dead. Legislation right now is required to prevent the discomfort of retroactive legislation at some time in the future.

petuities in a Nutshell" *Harvard Law Review,* LI (1938), 638, 653, n. 37: "This statute, computing the period of perpetuities from the exercise of special powers rather than from their creation, has amazing possibilities. Suppose that A, an economic royalist (and there are such in Delaware), leaves his estate to his son B, for life, remainder to such of B's issue as B shall by will appoint, with full power of delegation; then B exercises the power by giving a life estate to his son C, for life, remainder to such of C's issue as C shall by will appoint with full power of delegation; then C exercises the power in the same way and so on ad infinitum. Two consequences follow: (1) Property can thus be tied up in a family *forever* . . . ; (2) No federal estate tax is payable after such tax has been paid in the estate of A."

Failure to Tax Transfers from Life Tenant to Remainderman in Relation to Problem of Taxing Transfers of Property under Power of Appointment

The failure to tax transfers from life tenant to remainderman is closely related to the problem presented by the transfer of property under a power of appointment. Indeed it is principally because of the full exemption accorded transfers from life tenant to remainderman that a problem arises with respect to the exemption of property passing under the exercise of a power of appointment. Since transfers from life tenant to remainderman are exempt where the life tenant had no power to appoint, a difficult question arises as to just where to draw the line of exemption with respect to life tenants holding a power of appointment, since a special power of appointment may confer upon the life tenant only a very limited power of disposition.[5] If transfers from life tenant to remainderman were taxable, the problem of drawing the line of taxability with respect to transfers under powers would be eliminated, since the degree of control of the decedent over the prop-

[5] See Griswold, E. N., "Powers of Appointment and the Federal Estate Tax," *Harvard Law Review* LII (1939), 957.

erty transferred would no longer be the criterion of taxability.

Possible Solutions

1. *General statement.*—If the federal estate tax is to be protected as a source of revenue and if the importance for tax purposes of technical legal distinctions with respect to the nature of transfers of property is to be reduced to a minimum, either one of two alternative procedures must be adopted with respect to transfers from life tenant to remainderman. The first alternative is to formulate a hybrid estate tax base, including as taxable not only the transfer of property over which the deceased held a power of disposition, but also the transfer of property in which the deceased had merely a right of enjoyment during life.[6] The second alternative is to formulate a new and separate "acquisition" tax upon the remainderman's coming into enjoyment, coordinating this new tax with the estate tax paid by the life tenant on property over which he had a power of disposition. Such an acquisition tax could either stand alone or could form a part of an inheritance tax.

2. *Problems involved in the formulation of a hybrid estate tax base.*—In formulating a hybrid estate tax base to include transfers under property settlements it would be possible with respect to such transfers to tax only that which passed in enjoyment at each transfer. However, if only that which passed in enjoyment were to be taxed, the revenue potential of the estate tax would be reduced, not only because the present tax is imposed in the case of settled property upon the full value of the property in the estate of the settlor, but also because the right to control the devolution of a given property could be split into many separate parts by the time the property finally became subject to a transfer tax measured by its full value, thus providing escape from the graduated rates by means of multiple bases. Since it does not appear desirable to impair the revenue potential of the estate tax, this possibility will not here be given further consideration.

A second possibility with respect to transfers under settlements would be to tax the full value of the property at each transfer during the settlement, as the English do under their Estate Duty. If the full value of settled property were taxed at each transfer under the settlement, there would be no difference between the tax due on a transfer of property over which the decedent held full power to control devolution and the tax due on a transfer of property over which the decedent held no power to control devolution. This type of tax would regard the power to control devolution as an unimportant element of the property right for tax purposes. To the extent that the power to control devolution is an important element of the prop-

[6] This is the English practice under Great Britain's Estate Duty. Under the Estate Duty, all property passing on the death of the deceased is taxed. (Finance Act of 1894, Secs. 1 and 2 (1) (a)). "Property passing" includes not only property over which the decedent had a power to control the devolution, but also property over which the decedent was tenant for life in possession at his death, or property in which any other person had a beneficial interest ceasing on his death to the extent of the benefit so arising. (Finance Act of 1894, Secs. 1, 2 (1) (b) and 7 (7)). The phrase "to the extent of the benefit so arising" when applied to a transfer from a life tenant to remainderman *is interpreted to mean the full value of the property transferred, even though the immediate interest arising is nothing more than a life tenancy.*

erty right which should be considered for tax purposes, this solution of the problem is unsatisfactory.

A third possibility in formulating a hybrid estate tax base would be to tax only the interest arising in enjoyment in the case of a transfer from life tenant to remainderman while at the same time taxing the full value of the property at the transfer from the settlor to the first life tenant. The tax on the full value would be justified, since the settlor had full power to dispose. However, since the basic principle under this third possibility with respect to settled property would be to tax only the interest arising in enjoyment, the conceptual difficulties involved in handling the initial transfer from the settlor appear to warrant further search for a different approach to the problem.

3. *Imposition of an "acquisition" tax upon the right of the remainderman to succeed to the enjoyment of property.*—It is suggested that consideration be given to the possibilities inherent in the imposition of a new "acquisition" tax upon the right of a remainderman to succeed to the enjoyment of property. If such a tax were imposed, the present estate tax would remain undisturbed—a tax upon the transfer of property over which the decedent had, or could have acquired, a power to control devolution at sometime during his life. In the case of settled property, the full value of such property would continue to be taxable in the estate of the settlor. The "acquisition" tax herein suggested would not apply to the acquisition of settled property by the initial life tenant from the settlor, but would apply only to transfers from life tenant to subsequent life tenant or to ultimate remainderman. The taxpayer would be the remainderman acquiring the enjoyment of the property at the decedent life tenant's death. The base of this "acquisition" tax would be the estimated value of the interest acquired by the remainderman.[7] The rate of the tax, in order to minimize differences in tax burden due simply to technical legal distinctions as to the nature of the transfer, could be determined in relation to the size of the decedent life tenant's net estate for estate tax purposes. That is, if the life tenant had a net estate, the rates applicable to the remainder under the "acquisition" tax could be determined by applying to the value of the remainder the estate tax rates applicable to an additional amount of net estate equal to the value of the remainder. A refinement of this procedure would be to go one step further and equate the effective rate of tax applicable to the decedent life tenant's net estate with the effective rate of tax applicable to the remainderman's interest acquired under the settlement. If the decedent life tenant had no net estate, the tax could be determined by deducting from the value of the remainder an amount equal to the specific exemption allowed under the estate tax, and by then applying bracket rates equal to those applicable to a net estate of similar size.

[7] This is a tentative suggestion. If the full value of the property were taxed, it would be possible to eliminate entirely differences in tax due solely to the legal nature of property transfers. If it is felt that the power to dispose is an important element of the property right which should be given consideration in taxing property transfers, then only the value of the interest acquired by the remainderman should be subjected to the "acquisition" tax.

Summary and Conclusion

To protect the federal estate tax as a source of revenue, some form of tax must be imposed upon transfers from life tenant to remainderman. To adopt the English practice of including transfers from life tenant to remainderman in the estate tax base of the life tenant along with transfers of property over which he had, or could have acquired, a power of disposition would involve disregarding the power to dispose as an element of the property right in imposing a tax on property transfers. On the other hand, if in the case of settled property only the value of the interest arising at the death of the decedent were to be included in the estate tax base, the revenue potential of the estate tax would be impaired. An alternative solution is suggested—impose an "acquisition" tax on the remainderman, measured by the value of the interest received, so coupling this new tax with the estate tax as to prevent significant avoidance of the estate tax through the use of property settlements.

BIBLIOGRAPHICAL NOTE

Among general works on death taxation the reader will find the following most helpful: W. J. Shultz, *The Taxation of Inheritance;* Josiah Wedgwood, *The Economics of Inheritance* (London: George Routledge & Sons, Ltd., 1929); Randolph Paul, *Federal Estate and Gift Taxation* (Boston: Little, Brown & Company, 1942). The first is a general American treatise; the second is a British exposition featuring economic aspects; and the third is a monumental work on legal phases of the subject. Concerning the problem of taxing gifts the reader should consult C. Lowell Harriss, *Gift Taxation in the United States* (Washington, D.C.: American Council of Public Affairs, 1940). Intergovernmental relations in the field are comprehensively analyzed in Committee on Intergovernmental Fiscal Relations, *Federal, State, and Local Government Fiscal Relations.* A critique of present practices in death taxation and an argument for extending the death tax is presented in Harold M. Groves, *Postwar Taxation and Economic Progress,* Chap. 9. More conservative treatment of the subject can be found in Andrew Mellon, *Taxation: The People's Business* (New York: The Macmillan Company, 1924), and the Committee on Postwar Tax Policy, *A Tax Program for a Solvent America* (New York: The Ronald Press Company, 1945), Chap. 10.

CHAPTER 6

BUSINESS TAXES

IN THE largest sense all taxes are business taxes—the "tribute" which the public economic sphere takes from the private. But in a narrower sense some taxes are uniquely labeled as "business taxes" because they apply directly to business institutions (particularly corporations) or to their operation. Of these business taxes, some are general, cutting across the entire field of business, or at least corporate business; others are special, applying only to particular industries, such as public utilities, banks, or insurance companies. The propriety and advisability of taxing business as such is disputed, but the practice is widespread and is supported by distinguished authority and plausible argument.

If general business is to be taxed, the form of levy must be determined. Two broad classes of alternatives are available—those that apply to business costs and those that are confined to business surplus. In practice, business taxes present a bewildering variety of forms, including both cost and surplus levies. The confusion of the existing system is a favorite target for the critics.

The field of public utility taxation is rich with problems for students of taxation. The industry is uniquely monopolistic and regulated. This affords relations between the taxing and rate-regulating functions of government not found elsewhere in the tax system. Most public utility taxes are integrated into the general property tax system of the states; although they escape some general problems by central administration, they encounter others of their own. Among these are special valuation and apportionment problems.

Air transportation, banks, and insurance companies also afford unusual taxation problems. Chain-store taxation introduces the idea of checking business size through the tax system. Thus there enters into taxation literature a strain from the antimonopoly movement.

PAUL STUDENSKI

Toward a Theory of Business Taxation

THE author of this selection analyzes the rationale of business taxation. Unfortunately only a small part of this excellent article * could be reproduced here. In the parts not quoted the author analyzes the eight theoretical justifications of a business tax, all of which have some validity in his opinion. Businesses receive special privileges (limited liability) and participate in general services through the favorable environment provided by government. The notion that ability to pay is confined to individuals is "founded on the false association of business with the owners thereof." "The strictly personal or individual concept of ability to pay must be supplemented by an impersonal or group concept of it." It is conceded that business taxes may be shifted to the consumer but it is contended that the consumer should expect to pay, in part at least, for government as for other factors of production. A "social expediency" justification is derived from the revenue-producing possibilities of a business tax system. Finally, business taxation affords government a convenient means of social control.

The "value-added" tax suggested by the author would differ from a gross income tax in that the former would allow a deduction for the cost of goods processed and/or distributed. This would avoid duplication as goods move from one stage of preparation to the next.

Over the past half-century or more there has developed in this country a fairly elaborate structure of federal and state business taxes. This structure, as it is now constituted, is generally recognized to be singularly devoid of any plan and to be inconsistent in its underlying principles. At best it is the disordered product of fiscal expediency and piecemeal legislation—a more or less accidental conglomeration of tax laws, enacted at different times and applied to different types of businesses or different attributes of the same businesses, according to the exigencies of the moment. As such, it reflects a multitude of different ideas as to what constitutes a fair basis of taxation of business and is distinctly inequitable

* Reprinted by permission from *Journal of Political Economy*, XLVIII, No. 5 (The University of Chicago Press, Oct., 1940), 621–654. For a different view by the editor see Selection 32, Chap. 4.

in the distribution of its burden.

The time has arrived for the introduction of some order into this medley of unrelated, overlapping, and conflicting federal and state taxes on business. Such a task requires, however, the formulation of a sound theory of business taxation. Unfortunately, the amount of work done by our students of public finance toward the formulation of such a theory has not been very formidable. Our literature of taxation, although abounding in discussions of specific problems arising in the levy of certain business taxes, contains little fundamental discussion of the principles on which business taxes, taken as a whole, should rest. While most American public finance treatises describe the existing federal and state taxes on business, they almost completely avoid inquiring into their economic and social justifications.[1] Until recently the only really fundamental discussion of the subject was to be found in two articles written some twenty years ago by the late Professor Thomas S. Adams, for years adviser to the United States Treasury.[2]

Contemporary students of taxation who wish to contribute toward the formulation of a theory of business taxation must start, therefore, practically from scratch. This fact, while making their task more difficult, at the same time makes it much more challenging. Already some students have begun to explore the problem, so that we can expect that the present void in the literature on the theory of business taxation will be filled before long.[3]

The writer will attempt in the present article to develop his concept of a consistent and acceptable theory of business taxation and to indicate the changes which, in his opinion, should be made in the existing system of business taxation in order to bring it into conformance with such a theory.

Failure to Distinguish Between Businessmen and Business Enterprises as Collective Organic Units

Some citizens question the justification for the levying of business taxes. Their argument generally runs about as follows: "Business is an ac-

[1] See bibliography on business taxation in *How Shall Business Be Taxed?* (New York: Tax Policy League, 1937). Its section on the theory of business taxation contains only thirteen items. They are as follows: E. R. A. Seligman's chapter on the "Taxation of Corporations" in his *Essays in Taxation*, written before the enactment of the federal corporation-income tax and devoted largely to the discussion of the various bases of imposition of state corporation taxes; one of Thomas Adams' two articles listed below (n. 2); the second report of the National Tax Association's Committee on the "Model State Tax System"; two or three papers on state business taxes read before the latter Association's annual meetings; some minor articles by Buehler, Hunter, and Mudge; and finally, a page or two in each case in the textbooks of H. C. Adams, Shirras, and Shultz.

[2] "The Taxation of Business," *1917 Proceedings*, National Tax Association, pp. 185–94, and "Fundamental Problems of Federal Income Taxation," *Quarterly Journal of Economics*, XXXV (1920–21), 527–56.

[3] See Gerhard Colm's article, "Conflicting Theories of Corporate Income Taxation," in *Law and Contemporary Problems*, Vol. VII, No. 2 (1940); final report of the Committee of the National Tax Association on the federal taxation of corporations, of which Robert M. Haig was chairman, in *Proceedings*, October, 1939; and the author's own article "Taxation and Business Enterprise," in *Financial Management Series* (New York: American Management Association, 1939), No. 58.

tivity and a means by which individuals earn income and acquire property. It has no personality of its own. Taxes on business, therefore, are taxes on the individuals engaged in the conduct thereof. Since these individuals, however, are already taxed on their incomes, property and consumption, it is improper to tax them once again on their means of acquiring this wealth."

This argument, however, contains a fundamental flaw. It fails to take account of the fact that modern business taxes are levied on the operations of business enterprises rather than on the activities of businessmen; and it fails to recognize that modern business enterprise is, to a large extent, no longer the personal venture of the individual producer, inseparable from his personality, but is a complex organization or group venture having an organic unity and collective personality of its own. It also overlooks the fact that modern enterprise is generally a congeries of entrepreneurs, lenders of capital, managers, and employees; and that taxes imposed thereon may affect the incomes of all these producers and not merely those of the entrepreneurs alone. The argument is wrong in its assertion that taxes on business are really taxes on businessmen.

It is essential to a proper understanding of the nature of modern taxes on business to distinguish clearly between the business enterprise as a producing organization and the businessman as a factor of production. It is also necessary to the same end to keep clearly in mind the fact that nearly all the production in modern society is carried on through the instrumentality of business enterprises which are the basic productive units of the modern capitalistic economy, just as the manors or family households were the basic productive units of the feudal agricultural economy. An individual not attached to a business enterprise has very little productive capacity in modern society. His productive capacity becomes truly effective only when combined with the productive capacities of other individuals in a business enterprise. Finally, it is necessary to remember that the operation of business enterprises is impossible without the active co-operation of government.

The product of modern economic activity is collective, rather than individual, in character. Each individual participating in, or employed by, the enterprise receives an income supposedly commensurate with his contribution to the common product. Modern business enterprise has productive capacity which is impersonal in character and must not be confused with the personal productive capacities of the individuals participating in its functioning. This impersonal productive capacity is made up of the productive powers contributed thereto by these individuals and of a great many other factors—mechanical, governmental, social, natural, and fortuitous—which need not be listed here. It is the result of the effective combining of men, machines, and materials and the collaboration of government and society as a whole. Some business enterprises have large productive powers, others small, depending on their size, the quality of their management, the nature of facilities furnished to them by government, and other circumstances. Taxes on business enterprise are levied very largely, as will be described below, on

these collective and impersonal productive powers, though not necessarily in accordance with the amount thereof; and they must not be confused with taxes levied on individuals in their separate capacities as owners of property, recipients of income, and consumers.

The levying of taxes on business enterprises as such, separately from the taxes levied on property, personal incomes, and consumption, can be justified on one or the other of the following several grounds: (1) the special privileges conferred by the state on certain types of enterprises, (2) the special services rendered by the state likewise to certain enterprises, (3) the general services rendered by the state to all business enterprises, (4) the social costs or losses resulting from certain types of business operations, (5) the impersonal taxpaying capacity possessed by business enterprises, (6) general welfare, (7) social expediency, and, finally, (8) the possibility open to the state through taxes to exercise certain necessary social controls over certain types of business operation. Most of these grounds lead to different conclusions regarding the manner in which business enterprises should be taxed. Yet, these different grounds and systems of taxation supported by them are by no means mutually exclusive. Most of them may be, and generally are, readily combined.

* * * *

The Nature of the Federal Corporation-Income Tax

Having reviewed the principles which underlie and justify the taxation of business enterprise as such, let us examine the existing federal taxes on business enterprise and see to what extent, if at all, they conform with these principles. These taxes are comprised of the federal corporation-income tax, the capital-stock and excess-profits taxes, and the employers' pay-roll taxes. The most important one among them in its social and economic implications is the federal corporation-income tax. It will, therefore, be given special attention in this discussion.

At the very outset it is necessary to note that the federal corporation tax has assumed the character of a business tax pure and simple only very recently. For more than twenty years, since it was reconstituted, in 1913, as a part of the income tax, the tax functioned, in part, as a device for the collection of a portion of the personal income tax from stockholders at the source, inasmuch as under the provisions of the personal-income tax during that period an exemption was allowed from the normal rate thereof for the receipt of dividends. Only with the repeal of this exemption, in 1936, did the tax assume truly and completely the character of a business tax. The elimination of this provision was most fortunate, for it had, long since its introduction, ceased to operate as a perfect stoppage-at-source collection device and only contributed to the confusion of public thought regarding the true nature of the tax. It is to be hoped that this separation of the corporate-income tax from the personal-income tax will prove permanent in nature. If, as in the case of the so-called "undistributed incomes," it becomes necessary to collect some of the personal-income tax from stockholders at the source, this should be done preferably without

involving the corporation-income tax.[4]

Theoretical Justification for the Levy of the Federal Corporation-Income Tax

Of the several theories of business taxation reviewed above, only the privilege, state-partnership, impersonal-ability-to-pay, and social-expediency theories seem to have some application to the levy of the federal corporation-income tax. The applicability thereto of the privilege theory does not seem to require much elaboration. When the corporation tax was first introduced in 1909, it was known as an excise or franchise tax and was justified on the ground that the operation as a corporation is a special privilege.[5] This justification of the tax found its expression in the writings of some students of taxation long after the tax was reorganized in 1913 as a part of the income tax. Thus Judge Green in his book on taxation justifies the levy of the federal corporation-income tax entirely on the ground of the special privilege enjoyed by the corporations. "That corporations ought to pay something for this advantage," he says, "is a reasonable and generally accepted view."[6] Judge Green somewhat overstates the general acceptance of this view. Curiously enough, most of the writers, while justifying state corporation taxes on the ground of special privileges conferred on the corporations by the states, make no reference to the possible justification of the federal corporation-income tax on the ground of similar privileges indirectly conferred on corporations by the federal authority. Yet, it should be obvious that the main value of the corporate charter is in interstate commerce, since it enables the corporation to act on a nation-wide scale as a legal personality having divisible share capital, permanent existence, and limited liability. This privilege may be of little value to a small undertaking, but it is extremely valuable to a large enterprise. Without the corporate charter few, if any, large enterprises would have developed. The value of the corporate-charter privilege may be measured either by the size of the corporation's income or by the size of its assets. The relative merits of these two measures is a subject of debate.[7]

[4] The Committee of the National Tax Association on Federal Taxation of Corporations said upon this subject recently: "In our judgment substantial advantage may be gained if a distinct line of demarcation were drawn between (1) whatever tax may be imposed on corporate net income as a device for collecting at the source a portion of the personal income tax due from its shareholders and (2) whatever tax may be imposed on corporate net income as a part of a comprehensive business tax" (*Proceedings*, October, 1939).

[5] Said the Supreme Court in a decision sustaining the constitutionality of the tax, Justice Day delivering the opinion: "The Corporation Tax, as imposed by Congress in the Tariff Act of 1909, is not a direct tax but an excise . . . it is an excise on the privilege of doing business in a corporate capacity and as such is within the power of Congress to impose . . . it is a tax upon the doing of business with the advantages which inhere in the peculiarities of corporate or joint stock ownership" (*Flint* v. *Stone Tracy Co.*, 220 U.S. 107).

[6] W. B. Green, *The Theory and Practice of Modern Taxation* (2d ed.; Chicago: Commerce Clearing House, 1938), p. 104.

[7] Seligman, in his *Essays in Taxation*, years ago took the position that "the value of the [corporate] franchise from the economic point of view consists in the earning capacity of the corporation" and should be measured by its net income (8th ed., pp. 237 and 245). On the other hand, the National Industrial Conference Board in its report on *State and*

It would seem, therefore, that the levy of the federal corporation-income tax may be justified in part on the theory of the possession by the corporation of a special privilege.[8] The tax levied on this principle, however, should never be allowed to become so high as to wipe out the advantage which a business undertaking generally may derive from the possession of a corporate charter, thus prompting many undertakings to desist from incorporating. The effects of any such development on business activity would be most unfortunate.

The state-partnership theory affords a justification for the levy of the federal corporation-income tax in so far as the tax contains the elements of a general business tax. The same theory would afford a justification for the levy of a tax, on a net-income basis, on unincorporated businesses as well. However, there are very serious practical difficulties in the way of the application of this theory to unincorporated businesses. This difficulty lies in the imperfect character of the accounts maintained by unincorporated businesses, which stand in the way of an accurate determination of their net income.

The theory of impersonal taxpaying ability of business has only very partial and imperfect application to the levy of the federal corporation-income tax. That the levies under the tax bear only a very rough approximation to the taxpaying abilities of different enterprises is quite apparent from the previous discussion. In exempting enterprises earning no net income, the tax accords with the principle of ability to pay. In taxing all net incomes at the same rate, however, irrespective of the returns afforded thereby on the capital, the tax fails fully to comply with this principle.

The cost-of-service theory of business taxation, reviewed above, is clearly inapplicable to the levy of the federal corporation-income tax. There is obviously no close correlation between the amount and cost of the general services rendered by the federal government to different enterprises, on one hand, and the amount of net income earned by these enterprises, on the other. For the profits vary from enterprise to enterprise and from one period to another in the same enterprise—in the main, in accordance with other circumstances than the amounts of federal services rendered thereto. The amounts of the federal tax payable by different business enterprises, on the basis of their net incomes, bear very little relation, therefore, to the amounts and costs of the federal services rendered to them. Thousands of corporations receiving the services of the government are exempted from the payment of the tax because, for some reason or other, they have not earned a profit.

Local Taxation of Business Corporations (National Industrial Conference Board Studies, No. 164 [1931], p. 29) took the position that net income is not as good a measure of the value of corporate franchise as is the capitalization of the corporation "since the advantages of incorporation are inherent in the corporate form of organization without regard to whether or not business is done at a profit under such form of organization."

[8] It is interesting to note that the Committee of the National Tax Association on Federal Taxation of Corporations concedes in its recent report that "the present federal income tax on corporations might, in view of some of its formal characteristics, be classified as a corporate privilege tax," but, on the whole, finds it "preferable to discuss it as a variety of comprehensive business tax" (*Proceedings,* October, 1939, p. 567).

Defense of the Federal Corporation-Income Tax

Some people advocate the abolition of the federal corporation-income tax on the ground that (1) the compliance with its requirements require much labor and expense on the part of the taxpayers; (2) the tax discriminates against the most efficient enterprises; and (3) it provides a very unstable revenue. The first argument is correct, but it fails to take into account the fact that the complexities of the tax are due to a laudable endeavor to make it as equitable as possible and also to the complexity of business itself. The second argument is specious. The term "discrimination" implies unfairness. There is no unfairness, however, in the limitation of the tax to corporations earning a profit. Quite on the contrary, this limitation facilitates the operation of business enterprises, as it assures the corporations of a reduction on their tax liabilities at a time when they need such a reduction most. The third argument is true, but the weakness referred to therein is common to all taxes levied on the principle of ability to pay and is compensated by the other economic, political, and ethical merits of such taxes. On the whole, the federal corporation-income tax is just, its administration is improving, business enterprise has adjusted itself thereto, and the tax is fiscally productive. It would be a fatal error to abandon it or to curtail its efficiency.

The federal capital-stock and excess-profits taxes must be regarded as supplements to the federal corporation-income tax, intended to give a somewhat fuller expression to the theory of taxation of business enterprise in accordance with ability to pay than can be achieved thereunder. As at present constituted, however, these two taxes scarcely achieve this objective. They should give way eventually to a truly effective system of excess-profits taxation.

The federal pay-roll taxes on employers are business taxes in a very restricted sense. They can be justified partly on the theory of social costs. Since they are devoted to the financing of a special type of expenditure and are unique in many ways, they will not be discussed here.

The Need for the Levy of a General Federal Business Tax

It was stated at the beginning of this discussion that all business establishments, whether corporate or unincorporated, should be taxed by the federal government on the ground of the valuable character of the services rendered by the government thereto, and more or less in proportion to the amount and value of such services, in addition to being taxed on other bases. It remains now to consider what type of business tax can be so universal in character and can apportion some of the costs of government among business enterprises in this manner.

It would seem that the fairest measure of the relative amount and value of governmental services absorbed by different business enterprises for purposes of such general business taxation is the relative volume of the business activity of the enterprises. For the volume of such activity measures the extent to which any business enterprise utilizes the market maintained by society. The amount of capital or property possessed by an enterprise is, at best, only a very inexact measure of the

latter. This thought was expressed most clearly by Adams in 1917, when he pleaded for the imposition of a general business tax in the following terms: [9]

> Business taxes are imposed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market. Looking at the same question from another viewpoint, a market is a valuable asset to the social group which maintains it and the community ought to charge for the use of community assets. As a matter of pure business logic the government might well measure the tax by gross business, saying in effect to the business man: "You have come amongst us and have exploited our market; you have trafficked as much as your competitor; whether you have used your opportunity as well as he is not our concern. It is the gross volume of your trade which both represents your opportunity and causes our expense. Upon that you must pay."

There are two possible bases for measuring the volume of activity of business concerns for purposes of taxation: one is some form of gross receipts; the other is the so-called "value added." Among several possible forms of gross receipts we shall consider here only the gross receipts from sales which exclude income from investment and miscellaneous other sources.

* * * *

The Merits of a Tax on the Value Added

A far more accurate measure of the volume of activity of business enterprises, and hence also a fairer basis [than gross receipts] for the universal taxation thereof, is the so-called "value added," otherwise known also as "net-value product." It can be described as the gross sales of a concern less the costs of materials and services procured from other enterprises for use in production. It represents the net value of the labors of the establishment itself without any admixtures of the labors of other establishments and includes, in the main, the costs of labor, management, and capital employed by the enterprise and the returns due to the entrepreneur as a reward for his contribution to production. A tax based on the value added is relatively free from pyramiding. Under it each business enterprise is taxed on its actual production, that is, in the final analysis, on the relative use made by it of the market and other facilities maintained by organized society.

Under a tax on value added, at least a part of the cost of the services rendered by government to business would be treated by the enterprise as a cost of production and would eventually become incorporated in the price of its goods. Government would be treated as an agent of production in private enterprise, just as the entrepreneur, the lender of capital, management, and labor. It would share in the earnings of the enterprise together with the other agents of production, in proportion to its contribution thereto and, moreover, would share in them at the same time as they do.

The administration of a tax on value added would be relatively simple. The tax can be applied even to the smallest business concerns whose accounting may be quite imperfect. For every business, however small, has some record of its sales and the invoices or bills of its purchases. The tax would be susceptible of successful operation especially in

[9] *Quarterly Journal of Economics,* XXXV, 551–52.

the case of the manufacturing, wholesaling, retailing, transportation, and mining businesses. It would not operate as well in the case of agriculture and professions, where the value added consists mainly of the rewards of the entrepreneurs for their own labors and of the interest payments on their mortgages or other debts. It may be necessary to exclude these fields of occupation from the operation of the tax.

A tax on value added could be made exceedingly productive. If levied at the rate of 1 per cent, it would produce an annual revenue of more than $500,000,000, or almost one-half of the amount produced by the federal corporation-income tax and personal-income tax, respectively, at the present time. The value added amounts to about two-fifths that of the value of the sales in the case of manufacturing, one-fifth the value of the sales in the case of wholesaling, and one-fourth of the value of the sales in the case of retailing. In manufacturing and wholesaling, the value added is, on the average, from two and a quarter to two and a half times as great as the amount of the pay rolls;[10] in retailing, it is closer to being just two times as great. Accordingly, in the case of the aforementioned three fields of business, a 1 per cent tax on value added would be equivalent, in its fiscal productivity, to the rates of sales and pay-roll taxes given in Table 2.

A tax on value added would possess the added advantage of a comparatively stable revenue. Its yield would reflect changes in the total volume of business activity in exact proportion thereto. It would neither rise more rapidly during periods of prosperity nor decline more sharply during periods of depression than the volume of business activity. In a word, its yield would not be subject to any such extreme and highly disturbing fluctuations as that of the federal corporation net-income tax.

TABLE 2

Field of Business	Rates of Tax on Pay Roll and Gross Receipts from Sales Equivalent in Productivity to a 1 Per Cent Tax on Value Added	
	Percentage of Pay Roll	Percentage of Gross Receipts from Sales
Manufacturing. .	2.0	0.40
Wholesaling.	2.4	.20
Retailing.	2.0	0.25

Finally, a tax on value added could be used very effectively for the purpose of an apportionment, among the citizens generally, of the costs of some of the general services of government—such as a part of the costs of national defense—in accordance with the amounts of income expended by the citizens. A national defense tax of 4 per cent on value added would produce a revenue of $2,000,000,000 on the basis of present volume of business activity and

[10] The relationships given herein for manufacturing are based on the figures of the United States Census of Manufacturing; those for wholesale and retail distribution, on the surveys of Dun and Bradstreet's published in *Dun's Review*, July and August, 1939. These figures are not altogether comparable, inasmuch as the Census Bureau does not include in "value added by manufacture," the costs of supplies, obsolescence and depreciation, whereas Dun and Bradstreet in their figures of value added for wholesaling and retailing include these items.

more on the basis of a larger volume of business activity which the defense expenditures may be expected to generate.

* * * *

The Incidence of a Value-Added Tax

The incidence of a tax on value added cannot be easily determined, for it is subject to a great many varying influences. Inasmuch as the tax would become a part of the entrepreneur's costs of production, it would affect his profits and his pricing and production policies. He would try to shift the incidence of the tax forward to consumers by raising prices or, if this cannot be done, shift it backward to his employees, landowner, lenders of money, or suppliers of raw materials by offering them lower wages, rents, rates of interest, and prices. Finally, if neither can be done, the entrepreneur would try to introduce improvements in the methods of production which would lower the costs thereof sufficiently to absorb at least a part of the tax. If he fails in the accomplishment of either objective, he must content himself with lower profits; and, if he cannot earn any profits, he must go out of business.

Whether most of the entrepreneurs would manage to shift the tax one way or the other, or whether most of them would have to absorb it, would depend, in the main, on the conditions of the market at the time the tax is imposed and on the rate of the tax. Obviously, if the tax is imposed at a heavy rate at a time when the market is depressed and unemployment is prevalent, most of the entrepreneurs would be unable to pass the tax to the consumers, but some of them would be able to pass a part of it to the wage-earners and other groups mentioned. Either all or a part of the tax would have to be absorbed by the businesses. Some enterprises would be forced to close doors, and unemployment, as a result, would be accentuated. On the other hand, if the tax is imposed at a moderate rate at a time when the market is expanding and employment is increasing, most of the entrepreneurs would be able to pass the tax to the consumers. In either case, the possibility of shifting the incidence of the tax would be affected by the manner in which the proceeds of the tax are spent. If they are spent in a way to increase consumer purchasing-power, the entrepreneurs would find it easier to shift the incidence of the tax to the consumers than if these proceeds are spent in a way merely to cause a change in the types of consumption.

Although the general trend of the incidence of the tax on "value added" may be such as described, the actual incidence would most likely vary greatly from industry to industry, depending on its nature and the relative elasticity of supply and demand and existence of competition or monopoly therein.[11]

In the light of these facts it can scarcely be asserted that the incidence of the value-added tax would always be on the consumers and that the tax is merely a new type of a consumption tax. Nor is it possible to accept the opposite theory, advanced by some writers, that the incidence of the tax could never be on the consumers, inasmuch as the tax

[11] See a very suggestive analysis of the incidence of pay-roll taxes by Colm, some parts of which are applicable to the consideration of the incidence of the "value added" tax (*Social Research,* May, 1935, pp. 154–58).

applies to all business enterprises and does not change their competitive positions, and that the tax is likely to be distributed among the various factors of production in the exact proportion of the amounts of income obtained by them.[12] The tax on value added must be considered as being primarily a production tax. The fact that its incidence may be shifted, in part at least, to consumers does not establish it as a consumption tax, for the tax is adjusted to the peculiar features of production rather than to the peculiar features of consumption.

[12] This theory is advanced by Arant as follows: "Business organizations as such, not being able to shift the value product tax to consumers [a fact which the author postulated, but does not prove], would recoup the tax by passing it on as a deduction from the payment of wages, interest and rents. The tax falling on the net incomes of the receivers of those incomes, would not be susceptible of further shifting. . . . In the adjustment of wages, rent and interest rates, each individual employee, landowner and owner of capital would tend to suffer the same relative diminution from his marginal product. The burden of business taxation would be distributed to every individual engaged in production in proportion to his part in the social income. Competitive and other factors remaining the same, there is no reason to assume that there would be any alteration in the fundamental relationships of business. The burdens of business taxes would tend to be divided evenly, so that, after adjustments were made, competitors in the same business as well as those in different industries, and even their individual employees and other receivers of business income, would be left in their same relative positions" (*Tax Magazine*, April, 1937, p. 199, and May, 1937, p. 242). Apparently, the incomes of employers and employees, in his opinion, will be unaffected by the tax.

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NATIONAL TAX ASSOCIATION

Business Tax Recommendations of "The Model Plan"

NEARLY all critics are agreed that the business tax "system" of the United States is a hodgepodge, sadly in need of rationalization. A plan to accomplish this was proposed by a National Tax Association committee,* which recommended, first, that a profitable business be taxed on its net income and that business showing no profit pay a minimum tax on gross income or a flat amount, whichever were higher. The net income tax proposal is not discussed in the sections here quoted, which

* *1933 Proceedings,* National Tax Association, pp. 397–398; 399.

relate to the committee's original contribution suggesting a minimum tax. In effect, they propose three alternative taxes, the business to pay the highest of the three.

Section 35. In discussions had of the business tax recommended in the Report of 1918, the valid criticism has been made that, under its operation, business concerns would pay nothing whatever in bad years when their operations were not conducted at a profit. The tax in question is one designed to secure from every business a reasonable contribution toward meeting the expense of providing the various governmental services without which business cannot be carried on, which must be provided in bad years as well as good. These expenses must be paid by someone; and toward meeting them business may well be required to contribute even in years when no profits are realized and losses may have to be met.

We believe that the situation can be met by providing that a certain minimum tax be paid in any such year. After considering various minima suggested, we are of the opinion that there are two which are preferable to any of the others; the first based upon gross receipts, and the second based upon the amount of tangible property located in the state imposing the tax.

A tax upon gross receipts is easy to administer in these days when our people are accustomed to making returns of their income, returns which in the case of business income must include figures showing the gross sales. The rate should not exceed 1/10 of 1 per cent. Concerns doing such a small business that they are not required to make returns of their income can be reached, if desired, by charging a filing fee of some such amount as $2. With concerns carrying on interstate or foreign commerce, constitutional limitations are inevitably encountered. Foreign corporations can be taxed only on gross receipts derived from business done wholly within the state levying the tax. Domestic corporations, if they carry on interstate or foreign business, should be taxed on a proportion of gross receipts determined by the allocation fraction used in taxing net income. Thus levied, the tax may be free from constitutional difficulties. Here too, as in the discussion of net income, provision must be made for discretionary power in dealing with unusual cases.

To base the minimum tax upon the total amount of the taxpayer's tangible property located in the state is the second method. Although it may not avoid all constitutional difficulties, such a minimum tax has the advantage of ease in administration, and may therefore be favored by taxpayers. The rate of this minimum tax should not exceed 2 mills in each dollar of the fair value of the tangible property in the state; and this value should be the average book value of such property, as determined by the tax commission, less the depreciation reserve at the end of the year. In no case, however, should the tax be less than $5. Finally, concerns not required to make returns of their income under the business-income tax can be reached if desired by charging a filing fee of some such amount as $2. In some states, where the constitutions re-

quire that taxes on property shall be uniform and the power to levy excises is limited, the minimum we propose might be found unconstitutional. At this point, as at some others, adoption of our recommendations may be impossible without amendment of certain state constitutions; and to this subject we refer again in Section 54 of this Report.

* * * *

Section 37. The business tax we have recommended is proposed as a substitute for all such taxes now existing, except such as may need to be retained for the single purpose of police regulation. Like the former Committee, we are proposing a comparatively simple and uniform system to replace the multifarious, vexatious, and frequently unequal methods now employed in many of our states. While we believe that the tax we propose will produce more revenue, at least in ordinary times, than existing taxes, we advocate it quite as much as a measure conducive to equality and interstate comity as we advocate it as a revenue measure.

Reviewing the discussions that have been had of the previous Report and references made to it in the tax literature of the last decade, we find that the nature and purpose of the business tax have frequently been misconceived. The tax recommended by the former Committee was intended to apply objectively to all income from business carried on within a state, by residents or non-residents, and was to be in addition to any personal income tax that residents of the state might be required to pay. No state has seen fit to levy such an objective business tax upon all business, although taxes have been imposed objectively on the income of corporations. In general the tendency has been to include incomes of non-residents and incomes of corporations within the scope of a personal income tax, and then to call that part of the tax a business tax. Such a combination of inconsistent taxes has sometimes been represented as conforming to the recommendations of the former Report upon a Model System of State and Local Taxation. In fact, however, such legislation does not conform to the recommendations of the former Committee or to those we now make, while, for reasons set forth above, we believe it imposes unequal and discriminatory taxes upon interstate business and investments.

COMMITTEE ON INTERGOVERNMENTAL FISCAL RELATIONS

Extraterritoriality and Other Problems Arising from Migratory Corporate Domicile

ACCORDING to common interpretation, a corporation's domicile is in the state where it chooses to take out its charter, irrespective of where its property is located or its business conducted. Jurisdiction over domicile gives the state wide privileges of taxation. This combination of circumstances results in certain problems of business taxation and regulation considered below: *

5. *Control and Chartering of Corporations*

The question of which unit of government should have the responsibility of chartering corporations, and the control over such corporations that goes therewith, is mainly a matter of the proper division of functions between governments, but it is also a matter of considerable concern to the tax system.

(a) *State powers and competition in incorporation.*

Berle and Means refer to the business corporation as a "major social institution" and its development as a "revolution." [1] "It involves a concentration of power in the economic field comparable to the concentration of religious power in the medieval church or of political power in the national state." [2] The dominant position of the business corporation has been a matter of rather recent development, largely since 1890. Certainly the situation is vastly changed from that which prevailed when it was fashionable to take snuff and powder wigs. At present, the States have the power to grant corporation charters. They have sovereign powers in this respect, and these powers are respected by other States. The fact that a corporation may extend beyond the boundaries of the State that gives it birth and may in fact have only a nominal existence in that State is immaterial; so, also, is the fact that the corporation may be more powerful than the State which gives it birth.

An important element, too, in the

[1] Adolf A. Berle and Gardner C. Means, *The Modern Corporation and Private Property,* (New York: Commerce Clearing House, 1932), p. 351.

[2] *Ibid.*, p. 352.

* *Federal, State, and Local Government Fiscal Relations,* pp. 182–184.

question of functional allocation is the fact that State competition is exceedingly important in the chartering of corporations. The location of a corporation's business operations is likely to be a matter of the location of raw materials and markets, but the choice of a chartering State is not so conditioned. Few, if any, factors in our economic life are so exceedingly fluid as that of situs of incorporation. Add to this the fact that the chartering of corporations is of very substantial advantage to a State, that it affords the State some business connected with the granting of the charter, and considerable prerogative to tax, both at the time the charter is issued and thereafter. The result is that the States are singularly helpless to exercise any vigorous, independent control.

The above analysis is confirmed by experience. The competition first appeared when New Jersey, in the 'nineties, perceived an advantage in an incorporation law which allowed corporations large freedom to use the holding-company device for ownership and control in industrial combination. Other States were quick to follow this example. The very small State of Delaware has chartered over 100,000 corporations.[3] The terms under which these charters can be issued are very largely determined by the interested corporations themselves or by their lawyers located in the "charter-mongering" State. But the incorporation laws of all States are affected, and it has been plausibly stated that under modern conditions no State can afford to pass any stringent disciplinary incorporation laws.

[3] Testimony of John T. Flynn (subcommittee of the Senate Committee on the Judiciary, Hearings on S. 10, Federal Licensing of Corporations, 75th Cong., 1st sess., p. 50).

(*b*) *Concentration of corporate situs.*

The following facts concerning the location of principal executive offices and the State of incorporation for corporations reporting to the Securities and Exchange Commission are quoted from Statistics of American Listed Corporations.[4]

The location of the 1,961 registrants (based upon location of principal executive offices) was highly concentrated in New York and in 5 other States, in which nearly two-thirds of the registrants had their principal executive offices. New York alone accounted for 22 percent of all registrants followed in order by Illinois, Ohio, California, Pennsylvania, and Michigan, which ranged from 9.5 percent to 6.5 percent. New York was the location of principal executive offices of 5 (of the 7) corporations with assets of more than $1,000,000,000 each included in this report, the other 2 being in Michigan and Delaware. The same 6 States accounted together for 88 percent of the registrants with assets of $500,000,000 and over (New York alone: 63 percent); and for nearly three-quarters of the registrants with assets of $100,000,000 and over (New York alone: 39 percent).

Among the 48 States (and the District of Columbia) Delaware showed the largest number of registrants domiciled through incorporation. In all, 557 registrants (or 29 percent of all domestic registrants included in this report) were incorporated in this State.[5]

The reason for this concentration is indicated by the following figures which show that the proportion of registrants incorporated in Delaware has increased steadily since the adoption of the Delaware corporation law in 1899 and with

[4] Securities and Exchange Commission, *Statistics of American Listed Corporations* (Part 1, Summary Report, 1940), pp. 25–26.

[5] However, only 37 registrants (less than 2 percent) had their principal executive offices in Delaware.

each subsequent liberalizing amendment:

Percent of registrants incorporated in Delaware of all registrants incorporated during each period

Periods of incorporation:	
Before 1901	1
1901–10	5
1911–15	16
1916–20	27
1921–25	36
1925–30	51
1931–35	42
1936–37	53

As of 1937, 51 percent of the domestic registrants in the financial group [6] and 48 percent of those in the electric light and power holding-company group were incorporated in Delaware. Other industry groups where this percentage was high were chemicals (51 percent) and petroleum refining (50 percent). No clear correlation appears to exist between size and incorporation in Delaware, except that the smallest registrants (assets of less than $1,000,000) show the lowest percentage of companies incorporated in Delaware.

Prior to 1900 the State of New Jersey had offered what were in many cases the most advantageous terms of incorporation. This is reflected in the fact that of the 201 domestic registrants included in this report which were incorporated between 1875 and 1900, 49 (or nearly 25 percent) were incorporated in New Jersey while in subsequent years this proportion tended to decline, falling to 13 percent among registrants incorporated during 1901–10, less than 3 percent for those incorporated during 1911–20, and to 2 percent for those incorporated during 1921–30.

A slight majority (56 percent) of all registrants had their principal executive offices in the same State in which they were incorporated. Except for the smallest registrants (size of total assets less than $1,000,000) which showed a much more pronounced tendency in this direction, coincidence of State of incorporation and location of principal office did not seem to be influenced by size.

(c) *The movement for Federal incorporation.*

The movement for Federal incorporation of corporations doing an interstate business is not new. Bills to accomplish this purpose were introduced in Congress in 1911 and legislation of this character was supported by Presidents Taft and Wilson.[7] Two events in the New Deal period greatly affected the importance of the movement. One was the creation of the Securities and Exchange Commission with extensive powers over the issuance and sale of securities listed on exchanges. The other was court decisions which have in effect extended the definition of interstate commerce to include the production of goods intended for entry into such commerce as well as the actual movement of goods. The former makes the regulatory aspects of Federal incorporation legislation less important, the latter makes it more clearly feasible. That the regulatory aspects, including such matters as rules governing the use of proxies, reports, and the relation of directors to stockholders, are still of very great importance can hardly be doubted. In corporation regulation, as elsewhere in our governmental control of the economic system, cost of compliance by interstate concerns could be reduced considerably by the uniformity which Federal incorporation would tend to supply.

[6] As stated previously, this group excludes investment trusts, banks, and insurance companies.

[7] Testimony of Senator O'Mahoney (subcommittee of the Senate Committee on the Judiciary, Hearings on S. 10, pp. 34, 40).

But the taxation aspects of corporation charter-making are also of great importance. The State of incorporation gains a considerable tax prerogative by bidding for the location of corporations. That this creates a very inequitable situation in the tax system cannot be doubted. However, as in so many other cases, the inequity has led to important vested interests, sudden elimination of which would undoubtedly cause a shock. It might be necessary for the Federal Government to cushion the shock, were Federal licensing inaugurated, by the collection and distribution to the States of certain centrally collected revenues from the chartered corporations, such as the fees for incorporation. Perhaps temporary compensation might also be made for some part of the loss in corporate stock taxes. The present absentee incorporation practice creates difficulties of multiple taxation that would tend to disappear were Federal incorporation inaugurated. To be sure, something can and should be done about the multiple-taxation problem whether or not Federal incorporation is accepted as a solution.

Legislation requiring corporations doing an interstate business to secure a Federal charter would involve a considerable shock to business as well as to government. Business would be subjected to new requirements and to a new regulatory authority. But that incorporation of companies engaged in interstate commerce is a function which by all sound logic belongs to the Federal Government seems fairly apparent. The corporation involves very large and intricate problems of balancing the interests of security holders, management, and consumers. A wider perspective and a more strategic position than that possessed by the States is required for this task.

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MARTIN GLAESER

The Development of Public Utility Taxation

BUSINESS taxation involves the application of general and special taxes to special business as well as the application of special taxes to general business. Among the special businesses that figure heavily in the problem are public utilities. Some historical perspective concerning the taxation of these industries is provided in the following selection: *

* From *Outlines of Public Utility Economics* (New York: The Macmillan Company, 1927), pp. 578–582. By permission of The Macmillan Company, publishers.

Sec. 2. Stages in the Development of Public Policy with Respect to Public Utility Taxation

The changing attitude of the public towards public service corporations is reflected in the development of forms and methods of taxation as well as in the evolution of forms of regulation. During the greater part of the history of the United States, when much of the country was in a frontier condition of settlement, great inducements were held out to individuals and companies to encourage them in the development of public service enterprises. In tracing the history of public utility taxation Simpson has outlined five distinct movements and has assigned roughly the dates during which the ideas which lay at the basis of these movements influenced considerably the formulation of tax policies. Although, taken in the large, they have a very definite chronological sequence, there is a great deal of overlapping as to the time when these movements were effective and it cannot be definitely stated when one began and the other ended. These movements give us:

1. A period of subsidy from about 1790 to 1860.
2. A period of tax exemption from about 1790 to 1873.
3. A period of uniformity in taxation from about 1850 to 1890.
4. A period of differentiation in taxation resulting in special forms of corporate and of public utility taxation and extending from about 1873 to 1920.
5. A period of integration and of equalization of the burden of public service and other taxes within the single tax system.

The movement for integration and equalization is only now beginning. It aims to bring about equalization of the tax burden by systematic studies of the incidence of taxation and applying the results in the reconstruction of tax systems.

(*a*) *The period of subsidy.*

In order to bring about the construction of turnpikes, canals and railways most of the states early adopted policies of public aid through stock subscriptions, loans, land grants, and cash subsidies. Much of the enthusiasm for this kind of support was wiped out in the financial collapse of 1837 when some of the state treasuries were actually bankrupted.

The western states and the federal government, however, continued the practice of subsidy after it had been abandoned by other states. On account of constitutional prohibitions against investing state funds in internal improvements, the assistance often had to come from municipalities and counties which were authorized to subscribe to railroad stock. Competition among cities for transportation facilities prolonged municipal assistance, although under statutory limitations. The federal government was urged by the states to continue the policy even after the states had refused longer to participate. The courts upheld the use of public credit in the financing of public utilities on the ground that public utilities performed public functions.[1]

The result of this policy was a rapid development of transportation utilities. The improvements were pushed into territories so sparsely settled that they were unable to supply the volume of traffic and business

[1] *Dyar* v. *Farmington Village*, 70 Me. 515 (1878), also *Allen* v. *Inhabitants of Jay*, 60 Me. 124 (1872).

necessary for the continuance of profitable operations. This policy also gave us a period replete with graft and incompetent management, because much of the capital supplied by the public found its way into the pockets of promoters or was invested in such a manner as to be of little service to the public.

(*b*) *The period of tax exemption.*

Although the policy of direct subsidization was discontinued, public utilities were still looked upon as "works of necessity and grace" and hence the other early policy of almost complete exemption from taxation was not so easily discontinued. These tax exemption clauses were contained in early charters or in special acts and they conferred exemptions either for a term of years or in perpetuity.[2] Charters conferring such privileges were, of course, tenaciously retained, some of them well into the present century. The influence of the Dartmouth College decision was apparent. But the courts aided in another way by holding that even though exemptions were not specifically provided by statute, they could be implied from the charters, at least so far as local taxes were concerned, *unless there was specific authorization to tax.*

This insistence upon exemption in one form or another appears to rest upon the legal nature of enterprises providing turnpikes, highways, bridges, canals and railways. As in the case of subsidies, exemption was grounded upon the fact that the industries affected were regarded as public works and therefore exempt from taxation.[3]

Gradually a transition was worked out to the policy where public utilities like other enterprises were made subject to taxation. Exemptions were limited to terms of years corresponding to what appeared to be a reasonable developmental period. In this form exemption was continued as a policy until about the close of the nineteenth century. In another form, taxation was conditioned upon whether a public utility earned more than a specified dividend rate. Later, general incorporation laws for railroads, as in Ohio in 1848, reserved the right to tax. In the end the exemptions in the old special charters were eliminated by amendment or disappeared when the companies were dissolved.

[2] Professor Simpson's study contains illustrative details of this as well as other generalizations, and to these the reader is referred.

[3] Simpson produces this interesting illustration from *Inhabitants of Worcester* v. *Western Rail Road Corporation,* 4 Metcalf 564, p. 566 (1842), in which the Massachusetts court reasons as follows (after citing the usual powers and privileges of such companies):

"From this view of the various provisions of the law, by which the rights and duties of the Western Rail Road Corporation are regulated, it is manifest that the establishment of that great thoroughfare is regarded as a public work, established by public authority, intended for the public use and benefit, the use of which is secured to the whole community, and constitutes therefore, like a canal, turnpike or highway, a public easement.

"Treating the railroad then as a public easement, the works erected by the corporation as public works intended for public use, we consider it well established that, to some extent at least, the works, necessarily incident to public easement, are public works, and as such exempted from taxation. Such we believe has been the uniform practice in regard to bridges, turnpikes, and highways, and their incidents; and also in regard to other public buildings and structures of a like kind; as state houses, forts, and arsenals, court houses, jails, churches,

(c) *The period of uniformity.*

By 1850 a reaction against the policy of exemption set in, first in Ohio, and then throughout the Middle West. The reasons for the reaction are found in the hard times of the fifties, in the passing of frontier conditions, in the growth of "debtor" communities, in the increasing burden of public debt and taxation when the extravagances of the subsidization and public improvement policies had to be liquidated.

The uniformity movement, as it developed, involved changes in tax statutes, constitutional amendments, or new constitutions with "uniformity clauses." These clauses provided that all property be taxed under a uniform rule and upon the basis of its cash value. Political parties and farmers' organizations centered their efforts upon putting an end to the favoritism which had been shown the public utilities.

The system of taxation first applied to railroad, telegraph, and other public service corporations was the general property tax with local assessment. It proved a "dismal failure." With assessment in the hands of local assessors taxes were evaded. Their experience with, and knowledge of, methods of ascertaining the cash value of properties extending through several states and many taxing districts was woefully inadequate. There was corruption of local tax officials by means of passes and special privileges. The character of railroad property itself introduced the possibilities of wide discrepancies in the assessment of property in adjacent taxing districts. Where honest attempts were made to derive a true valuation, the efforts were thwarted by the failure of the companies to supply the necessary or the correct information. The period was therefore marked by wholesale evasion of taxes and gross inequalities in assessment.

In some cases, as in Ohio, the carriers were required practically to assess themselves and to apportion the assessment among the various counties. Later, assessment by a board of assessors made up of the auditor of the counties through which each railway ran was tried. Similar methods were applied in the case of street-railway, gas, water and bridge utilities. Always, the public utilities found some method of evading the tax burden.

(d) *The period of special taxation.*

Taken in connection with the growing movement for rate regulation, these results could not fail to bring on drastic action. The Granger, Populist, and other radical movements, growing out of economic conditions which obtained during the last three decades of the nineteenth century, were instrumental in bringing on further attempts to force utilities to assume a greater tax burden.

The development of a more satisfactory system of taxation, both in the matter of legislation and administration, was retarded by conflicts over jurisdiction between the

town houses, school houses; and generally to houses appropriate to public uses."

This decision well illustrates one aspect of the thesis upon which this treatment of public utility economics is based, namely, that the concept of public utility is an institutional growth which involves drawing a line of demarcation between public services on the one hand and private businesses on the other. In this instance, the court is conscious of the fact that railways are not private in character, but the line between public services and public utilities is painfully indistinct.

local taxing districts and the states. The very constitutional provisions for uniformity which had initiated public utility taxation now stood in the way of a correction of the weaknesses. The difficulties which the movement for rate regulation encountered induced its proponents to try the use of the taxing power as an instrument for recovering what were regarded as excessive earnings. All these movements are epitomized in the "anti-corporation" feeling with which the discontented elements countered the "public-be-damned" spirit of the American phase of the Industrial Revolution.

Nevertheless, the difficulties in the way of more effective taxation of public utilities were gradually overcome by a series of special tax laws designed to get around constitutional obstacles. So many special forms of taxations were devised that state tax systems became a confused mass of unrelated tax measures, enacted without any basis of principle except that of securing increased revenues out of corporations in general, and out of public utilities in particular.[4] The more common types of special taxation were (a) the various forms of taxes on corporate franchises; (b) taxes assessed upon earnings either gross or net; (c) modifications of the general property tax as applied to corporate property, with ad valorem assessments; (d) the various forms of excise taxes on corporate capitalization, such as taxes on the normal value of capital stock, on the market value of the shares, on tonnage carried or other traffic unit, on instruments employed or other convenient index of business, on transactions, and a host of other variations.[5] Only typical ones among these special forms of taxation applying to public service companies will be discussed, particularly those that were more generally adopted and that have maintained themselves until the present time.

[4] This idea has been represented as "plucking the goose with the least squawking."

[5] No useful purpose would be served in presenting the details. The general reader, seeking only orientation, would be wearied by the recital and confused by the lack of system with which the various forms were combined.

RONALD B. WELCH

Railroad Assessment

THE application of the general property tax to railroads has been and is a major problem of state and local taxation. A main feature of the problem, discussed in the selection * below, is that of appraising railroad property to arrive at a tax base.

Value evidences.—As pointed out in chapter II, the State tax laws direct that property be assessed at full cash value, actual market value, true value, and so on. These laws differ in their language but agree in their meaning. They mean that a property is to be assessed at the price that would have been set in a transfer between an informed buyer and an informed seller acting deliberately, voluntarily, and "at arm's length" had the sale occurred on the assessment date. The fact that railroads are not often sold does not alter the substance of the law; it merely means that recent sales prices are seldom available as evidence of what the property might have been sold for on the assesment date. However, there are various other evidences of value that are commonly employed by railroad assessors. The most important of these may be classified under four headings: (1) Earnings, (2) stock and bond prices, (3) depreciated cost of the property, and (4) the prior year's assessment.

Earnings as evidence of system value.—The first of these types of value evidence is the one that is most popular with railroad assessors.

* * * *

The case for consideration of capitalized income in appraising property is clear. In essence it is the market adage that "property is worth what it will earn." This relationship between value and income received early recognition by the United States Supreme Court, when Mr. Justice Brewer, writing the opinion in *Cleveland, etc., Ry.* v. *Backus,* said.[1]

> The rule of property taxation is that the value of the property is the basis of taxation. It does not mean a tax upon the earnings which the property makes, nor for the privilege of using the property, but rests solely upon value. But the value of property results from the use to which it is put and varies with the profitableness of that use, present and prospective, actual and anticipated. There is no pecuniary value outside of that which results from such use.

This passage, it will be noted, speaks of "present and prospective, actual and anticipated earnings," not of past earnings. Herein lies a major

[1] 154 U.S. 439, 445 (1894).

* *Carrier Taxation,* House Doc. 160, 79th Cong., 1st Sess., pp. 102–111.

problem in the use of earnings as evidence of value. Buyers of a railroad are not buying the past; they are buying the right to receive future income. Past income is therefore useful as an evidence of value only to the extent that it provides evidence of future income. But, since future earnings are a matter of prediction, not of record, assessors customarily look to the past earnings for guidance. In doing so, most of them reason as follows: Past earnings are the best evidence of future earnings, and future earnings determine present value; therefore past earnings are the best evidence of present value.[2]

Granting that past earnings are often the best indication of future earnings, the appraiser is next confronted with the problem of selecting an appropriate earnings period. Should earnings of the past year be used? Or is a 3-, 5-, or 10-year average more appropriate? Upon this question there is naturally much disagreement. Many States adhere strictly to a 5-year average. Professor Daugherty found a few years ago that this was used as an evidence of value—though not necessarily as the only earnings evidence—in 77 percent of the States for which he could obtain information,[3] and the Board's studies show that this period had lost little of its popularity up to the year 1942. The next most common period in use is 3 years. However, assessors in three States capitalized a 10-year average of net railway operating income in arriving at their 1942 assessments; and several other agencies now, as in former years, consider capitalized earnings of the most recent year, together with capitalized average earnings of 3, 5, or more years.

Most State assessing agencies average earnings over the same period for all roads year in and year out. Occasional departures from this rule of uniformity in other States might be critically interpreted as a deliberate attempt to select the period most favorable to the State. But this does not seem to be a fair interpretation. One might more justifiably criticize the strict adherence of many State assessors to a given earnings period without regard for probable future trends. This adherence may be simply a matter of inertia. Or it may reflect a conscious desire to stabilize assessments in the face of fluctuating market values and to mete out a rough sort of justice by overassessment in the downswing of the business cycle and underassessment in the upswing. At any rate, it should be clear that an assessor whose purpose is to arrive at market values cannot simply capitalize an average of a given number of past years' earnings without variation from one year to another or from one railroad to another.

Indeed it may be questioned whether there is any justification in appraisal theory for the averaging of past earnings at all. The purpose of the averaging process is to secure a single figure which, when divided by a capitalization rate, will produce a result representing the value of the property. This would work well enough if all future annual earnings were expected exactly to equal the

[2] Strictly speaking, future earnings determine "warranted price" rather than "present value" as that term is defined by economists, but warranted price is usually regarded as the most equitable basis for taxation of railroads or the closest available approximation of present value.

[3] M. M. Daugherty, "A Study of the Methods of Assessing Railway Property for Tax Purposes," *Proceedings of the National Tax Conference,* XXXI (1938), 314.

figure that has been capitalized. If, however, future earnings are expected to vary, and the appraiser has some notion of the direction and extent of variation, a literal application of appraisal theory requires that he discount separately each future year's income to its present worth and add the results of these separate computations to secure the value of the property. The assessment process might easily become entangled in a maze of complications by adhering to the letter of appraisal theory in this respect, but there are practicable intermediate levels between capitalizing average earnings for a certain number of past years and discounting separately the anticipated earnings of each future year.[4] Several of the leading railroad appraisers in the property-tax field are regularly or experimentally operating on such levels.

A second variation in the use of earnings by railroad appraisers is found in the rate of capitalization. The rates in use for property-tax purposes in 1942 ranged from 4 to 8 percent, a most significant range in view of the fact that the first gives an appraisal exactly twice as high as the second. Here again, however, the range may not be as significant as the lack of it. Most States use 6 percent year after year with little thought as to the proper rate of return upon investments in railroad property. In 1942 the 4-percent rate was used in only two States and there in conjunction with many other evidences of value. The 8-percent rate was used in only one State and apparently was given little weight, for the final assessments could be justified only by capitalizing income at a considerably lower rate.

One can only speculate as to the reasons for the prevalence of a 6-percent capitalization rate. Jacoby attributes it to the Transportation Act of 1920, which prescribed a fair return of 5½ percent, and to the increased rate case of 1920, wherein the Interstate Commerce Commission, under authority granted by the act, raised the fair rate of return to 6 percent.[5] A more common explanation is that 6 percent is the maximum legal rate of interest in many States. Of the two reasons, the first is much the more persuasive. However, it is not a particularly compelling argument for the use of a 6-percent rate during periods of depression when a fair rate of return on railroad properties was a more or less academic question.

Those assessors who wish to choose rather than inherit a capitalization rate may pursue either of two courses. They may study the relation of stock and bond values to prior earnings, or they may study the rates at which new loans are floated on the market. Some investigations of the former type have been made at the request of the Kentucky Revenue Department,[6] but they do not cover carriers. The principal example in the carrier field is the 1904 valuation of the railroads by the Bureau of the Census.[7] While these and other simi-

[4] See W. H. Wallace, "Summary of Discussion at the Model Railroad Assessment Hearing," *Proceedings of the National Tax Conference,* XXXV (1942), 172.

[5] Neil H. Jacoby, "The Rate of Capitalizing Railroad Earnings to Establish a Valuation for Property Taxation," *The Journal of Business of the University of Chicago,* XIII (1940), 159–160.

[6] Richard B. Goode, *Valuation by Capitalization of Earnings* (Bulletin of the Bureau of Business Research, the University of Kentucky, June 1939).

[7] *Commercial Valuation of Railway Operating Property in the United States: 1904*

lar studies have not produced data currently useful to railroad assessors, they have cut the pattern of procedure. It may reasonably be anticipated that the pattern will be used more extensively in postwar years than it has been heretofore.[8] The method is by no means perfect,[9] but it is undoubtedly better than no method at all and has much wider applicability than studies restricted to new security issues.

A final problem in the use of earnings as evidence of value is the definition of the term "earnings." It is apparent from the preceding discussion that net rather than gross earnings are used. True, gross earnings often serve to indicate the trend of values and the relative values of different roads. However, they afford only indirect evidence of present worth.

There are several net earnings concepts that may be used by railroad assessors as direct evidence of value. "Railway operating income" [10] with minor adjustments, is the figure that would be used if all operating property, including rolling stock and joint facilities as well as leased lines, were to be included in the unit appraisal of the using road.[11] If the purpose is to assess cars and joint facilities to the owner and all other operating property to the user, then "net railway operating income" is employed.[12] And if all property owned, both operating and nonoperating, plus leased roads and equipment, is to constitute the unit of appraisal, all "income available for fixed charges" may be capitalized.[13] Almost all assessors use the second of these figures, net railway operating income.

* * * *

Stock and bond prices.—Next to earnings, stock and bond value has had the widest acceptance as an evidence of the value of railroad property. The theory of this approach to the appraisal problem was set forth by the Supreme Court in State Rail-

(Washington: Bureau of the Census, Bul. No. 21, 1905).

[8] For important details concerning methodology, see Jacoby, *op. cit.*, and J. W. Martin, "Corporate Taxes and the Assessment of Public Utility Operating Property," *Journal of Land and Public Utility Economics,* XVI (1940), 268–269.

[9] The prices at which stocks and bonds are quoted presumably are much influenced by the future prospects of the issuing corporation, whereas it must be assumed for purposes of this type of study that purchasers are capitalizing income of the current or prior years.

[10] In railroad-accounting terminology, this is the figure derived by deducting operating expenses and railway tax accruals from operating revenue.

[11] There should be deducted from railway-operating income that portion of the "rents payable" that represents payments for depreciation and repairs borne by the owner of the property, and there should be added the portion of rents receivable that covers depreciation and repairs on property owned but not used by the road. The purpose of the first adjustment is to reduce the net income of the using company by the operating expenses attributable to the property used, while the second adjustment adds to the net income of the owning company the amount of operating expenses incurred by the company on property that is used by other taxpayers. If the railroad has substantial non-carrier activities, allowance should also be made for the fact that some of the railway tax accruals relate to corporate activities as a whole and not just to railway operations. See J. W. Martin, *op. cit.*

[12] "Net railway operating income" is railway operating income plus rents received from car hire and joint facilities and less rents paid for car hire and joint facilities.

[13] Fixed charges are comprised of interest on funded and unfunded debt and rent of leased roads and facilities (other than joint facilities). Income available for fixed charges is the sum of net railway-operating income and net income from sources other than railroad operations.

road Tax Cases.[14] The Justice who wrote the opinion regarded it as obvious that—

> . . . when you have ascertained the current cash value of the whole funded debt, and the current cash value of the entire number of shares, you have by the action of those who above all others can best estimate it, ascertained the true value of the road, all its property, its capitalized stock and its franchises; for these are all represented by the value of its bonded debt and the shares of its capital stock.

This quotation discloses one of the points of controversy in the application of the stock-and-bond method of appraisal, a controversy which is invoked, in fact, by the very name applied to the method. Many commentators wonder why only the "funded" debt should enter into the calculation. The usual reply is that the unfunded debt is offset by assets that are not taxable. This, however, is an unsatisfactory answer. It erroneously assumes that certain assets are paired with certain liabilities and that there is a necessary equality between the two. The correct approach is to include in the stock and bond value, or to use a more accurate terminology, the "stock and debt value," all valuable claims against the assets, whether they be funded or unfunded, contingent or fixed, legal or equitable. From the total value of stock and debt there may then be deducted all assets that are not taxable.[15]

Perhaps the most controversial aspect of the stock-and-bond method of appraisal is the period over which security values are to be averaged. If the securities of the company in question are actively traded, there is much to be said for the use of spot prices as of the assessment date, since the purpose is to arrive at the value of the assets as of that date. But this policy has few advocates, and has been adopted by no State tax department. Instead, 1-, 3-, and 5-year averages are employed in various jurisdictions and at various times. It must be admitted, however, that the selection of a period has little basis other than habit and the ever-present desire to stabilize assessments.

It is commonly assumed that the reasons impelling appraisers to use an average of earnings for several prior years demand that stock-and-bond values be averaged over a similar period. But the analogy is false. Earnings are averaged because the appraiser is seeking an average of future earnings, and he is obliged to assume that there will be good and bad future years as there have been good and bad past years.[16] But when

[14] 92 U.S. 575, 605 (1875).

[15] Indeed, as Bonbright says, "The purpose for which a debt was incurred has no proper bearing on the inclusion of the value of this debt under the stock-and-bond method of enterprise valuation. Any debt is to be included, not because it represents a capital investment but rather because it constitutes a valuable legal interest in the entire enterprise. The mere fact that the debt may have been incurred to pay operating expenses, or even to pay a bribe to a politician, does not render it any the less a claim against the corporate enterprise, so long as the debt is concededly enforceable. . . . A queer but persistent psychological fallacy, associated with the well-recognized failure of accounting novices to distinguish clearly between asset items and liability items, probably explains this tendency of assessors and courts to assume that, under the stock-and-bond method of valuation, current debts should be ignored even though funded debts are included" (*The Valuation of Property*, pp. 573–574.)

[16] As Jacoby has pointed out (*op. cit.*, pp. 162–163), this reasoning supports the averaging of past earnings over the normal pe-

using the stock-and-bond method, the assessor's purpose is to find the "true" value of the stocks and bonds on the assessment date, and an average of quotations for a period of several years is not obviously superior to the spot prices. An average for a relatively short period, say 1 or 2 years, on the other hand, tends to overcome the objection that the quotations for any one day are established by the trading of a small fraction of the outstanding securities, and hence may be unduly influenced by the personal circumstances of the traders or by the alleged vagaries of the market.

It is only fair to say that the stock-and-bond method of appraisal is held in low regard by a majority of railroad assessors. While the States that adhere closely to a formula give as much weight to stock and bond values as to capitalized earnings, most of the other States give little credence to such values. Their objections to the method were aptly stated by Judge Webster in *Northern Pacific Ry.* v. *Adams County*[17] in the following terms:

> It requires the fixing of a period over which the market quotations shall be averaged, and this of necessity must be a more or less arbitrarily fixed period of time; it assumes that the average value of the stock and bonds actually sold reflects the value of the entire outstanding issues of each, when rarely ever is the controlling interest in stock and bonds of a railroad company bought or sold on the stock exchange, and where control or ownership of a corporation is sought, it is common knowledge that the securities sharply advance in price; it assumes that the aggregate market value of the stock and bonds issued by a corporation is the same as the market value of the property owned by the corporation and which underlies the securities; it presupposes an idealistic knowledge and state of mind on the part of those who deal in such securities on the stock exchange in that it assumes that the purchasers of the securities act upon an informed judgment based upon accurate information as to the character and extent of the assets of the corporation whose securities are involved; and it largely ignores the influence of pure speculation in the market on the part of those who do not even pretend to possess accurate information with respect to the assets and affairs of the corporation whose securities are bought and sold.

These words were spoken in the early years of the depression, when the anomalous spectacle of stocks selling at less than their shares in net quick assets were painful memories to many erstwhile investors and when the reputation of the stock market was at its lowest ebb. They took on added meaning to railroad assessors as several of the major railroads fell into receivership and stocks and bonds tumbled to a fraction of their former worth. It was contended, and apparently with good reason, that defaulted securities went well below their true values because many large investors—the insurance companies, banks, and institutional investors—could no longer legally acquire them and were often obliged to liquidate their previous purchases at whatever prices they could get. Under such circumstances, the stock and bond value of a road in receivership was generally regarded as far out of line with that of a nonreceivership road even though the latter might be tottering on the brink of bankruptcy.

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riod of a complete business cycle, which he regards as at least 9 years. However, such an average, while allowing for cyclical movements, does not allow for a secular trend.

[17] Fed. Supp. 163 (1932).

Another objection to the use of this appraisal method is that it gives double weight to earnings.[18] This objection seems ill-founded for two reasons. First, it is clear that the earnings which are used by the vast majority of assessors are past earnings, while there is at least a presumption that purchasers of stocks and bonds are primarily concerned with future earnings; thus the stock-and-bond method is the only way in which most States take any account of future earnings, the all-important determinant of present values. Secondly, there is no reason why one evidence of value should be ignored just because it may differ little quantitatively from another. It is quite true that those who assess by formula give less weight to depreciated cost by averaging it with both capitalized earnings and stock and bond values than by averaging it with only capitalized earnings. But if this is regarded as undesirable, the desired result might better be achieved by giving more weight to depreciated cost than by ignoring stock and bond values altogether.

It is further urged that many issues of railroad securities are not listed on the exchanges and are infrequently or never quoted elsewhere.[19] Although this complaint stems to some extent from the attempt to assess to owners what might better be assessed to users of railroad property, it is for the most part a convincing one as far as it goes. Assessors look with disfavor upon the "constructive" or "synthetic" values that are concocted for unquoted securities by capitalization of earnings and dividends, comparison with other securities of the same road, and comparison with quoted securities of other roads. Nevertheless, some synthesizing of values is required for almost all roads, and the procedure is a desirable one when at least the major issues are quoted.

Stocks and bonds get their value from all of the property owned by the issuing corporation and are regarded as unreliable evidences of the value of railroad operating property when the corporation owns nonoperating properties of considerable value.[20] If the stock-and-bond method is employed to appraise a railroad owning nonoperating property, it is usually necessary to appraise such property separately and deduct the result from the stock and bond value. The nonoperating assets are variously appraised by reference to book values or to local assessed valuations, by capitalization of nonoperating income, or by some combination of these basic methods. The purpose is to find the extent to which the stock and bond values are enhanced by the corporation's ownership of these assets and this purpose is thought by some of the leading practitioners to be best served by

[18] Harley L. Lutz, *The Taxation of Railroads in New Jersey* (Princeton: Princeton University Press, 1939), p. 91.

[19] While this is true as to number of issues, many of the largest issues are quoted. It was estimated by Professor Sorrell that 70 per cent of the outstanding railroad bonds and common stocks and 87 percent of the preferred stocks were listed on the New York Stock Exchange a few years ago. (L. C. Sorrell, *Government Ownership and Operation of Railways for the United States.* [New York: Prentice-Hall, Inc. 1937] p. 277.) When allowance is made for listing on other exchanges and for over-the-counter quotations on unlisted securities, this indicates that the objection stated in the text is insufficient ground for abandoning the stock-and-bond-method of appraising railroads.

[20] Illinois Tax Commission, Twenty-first and Twenty-second Annual Reports, p. 97.

the income-capitalization method. Again, the stock and bond values may have to be adjusted if property is to be assessed to users rather than owners. A railroad owning property that it does not use will receive a downward adjustment, and the reverse will be true of a corporation using property that it does not own.[21] The larger these adjustments to stock and bond values, the less reliable is the final appraisal by this method.

But the principal objections to this method of railroad valuation seem to be those voiced by Judge Webster in the passage quoted above. These criticisms add up to the belief that stock and bond values, however perfectly computed and adjusted, do not accurately testify to the value of the underlying assets. One cannot effectively defend this position unless he has a reliable alternative method of appraising the underlying assets and thus securing a "true" value against which to test the accuracy of the stock and bond value. An examination of the alternative method may reveal that it is as weak as, or weaker than, the stock-and-bond method itself. Thus, capitalized prior earnings are unreliable because value is essentially dependent upon prospective earnings, not prior earnings, and because the proper rate of capitalization is indeterminate. Original or reproduction cost less depreciation is unreliable for reasons to be developed subsequently. Anticipated future earnings discounted to their present worth are theoretically superior to stock and bond values, but the appraiser is not necessarily a better prophet than those who stake their money on their predictions of future earnings by buying and selling railroad securities. And even if the appraiser were an excellent judge of earning prospects, stock and bond values would have the advantage of being objective and would merit the support of those who believe that a little objectivity is worth a great deal of accuracy.[22]

Cost as evidence of value.—The third group of value evidences differs from those previously discussed in two important respects. First, the cost of property is not ordinarily used as evidence of the *unit* value of an interstate railroad, for much of the cost data that are available for a railroad system are separable as between States. This difference is significant for allocation purposes but not in the appraisal process. Second, there is a great deal of controversy over the use of cost data as an evidence of value. Most railroad tax representatives and private appraisers argue that such data are irrelevant, and the courts and many tax administrators insist that they be given at least some consideration.

Several different cost concepts are used by railroad assessors, including original cost, reproduction cost as of the assessment date, and the physically depreciated counterparts of each of these costs.[23] Since there is

[21] George W. Mitchell, "Use versus Ownership as a Basis for Taxation," *Proceedings of the National Tax Conference,* XXXI (1938), 289.

[22] Cf. Bonbright, *op. cit.,* p. 248.

[23] It is not customary to speak of the "reproduction cost" or the "reproduction cost less depreciation" of land. However, it will be convenient in this and subsequent sections to include land within the meaning of these terms, with the understanding that the reproduction cost of land means, in substance, the current cost of acquiring it, as evidenced by the value of adjacent land, and that no depreciation is to be offset against such cost. It will also be convenient to use

no substantial body of opinion favoring the use of undepreciated cost as an evidence of value for tax purposes, it is possible to restrict the discussion to original cost less depreciation and reproduction cost less depreciation.

There are well-known reasons why market value is related to cost of reproduction in a competitive economy. If market value goes above depreciated reproduction cost, prospective buyers will construct their own properties rather than buy them on the market, speculators will increase the supply and thus tend to lower the market price, and costs attributable to specialized labor and materials will tend to go up. All of these forces working together will tend to equate market value and reproduction cost. If, on the other hand, market value goes below depreciated reproduction cost, goods will not be replaced when they wear out, and costs of specialized labor and materials will tend to go down. The equation of cost and market prices in this case may be slow, particularly for long-lived properties, but it must occur in the long run if worn-out properties are to be replaced.

Aside from the fact that the market values of long-lived properties often fall below their physically depreciated reproduction cost, there are other reasons why the analysis in the preceding paragraph does not justify heavy reliance upon cost data as evidence of the value of a railroad system. For one thing, the prospective buyer of a railroad does not always have the option of building a new road if he finds that the asking price for existing roads exceeds depreciated reproduction cost. One can build a new railroad only with the permission of the Interstate Commerce Commission, and permission is not certain to be granted merely as the result of such a finding. Furthermore, the Federal and State regulatory bodies not only have the authority to restrict entry into the railroad business but they can, within the vague limits of due process of law, prescribe railroad rates and establish standards of service. Under favorable demand situations, the regulatory agencies can approve rates that will cause market values to exceed reproduction cost; they can also prescribe rates that force market values below reproduction cost or require the replacement of worn-out properties even though they cost more to reproduce than they add to the market value of the railroad. For these several reasons, reproduction cost is a far less useful guide to the value of a railroad than to the value of a home or an automobile.

Original cost less depreciation, when used as an evidence of value, has limitations even more serious than reproduction cost less depreciation. Original cost tends to be high for a road largely constructed in periods of high prices and low for others that were constructed at more favorable price levels, and there is no necessary reason why the values of the two roads should vary to the same extent or even in the same direction. However, regulatory agencies do consider original as well as

the term "depreciated reproduction cost" to mean reproduction cost, less physical depreciation but with no reduction for obsolescence. Since a railroad's obsolescence can be determined only by comparing physically depreciated reproduction cost with capitalized earnings or stock and bond values, obsolescence is not ordinarily deducted in arriving at the cost data used by railroad appraisers.

reproduction cost in rate making; and, to the extent that market value is affected by the rate base, original cost is relevant to the tax-appraisal process.

The relationship between the rate base and the market value of a railroad has often been misunderstood. The misunderstanding arises largely from the fact that the rate base is called the "value for rate-making purposes." Actually, the rate base is not "value" at all in the commonly accepted meaning of the word, although it does come within Professor Bonbright's definition of value "in its very broadest sense" as "any one of the many alternative ways of associating items of property with sums of money . . . a mere colorless expression for 'dollar amount.' "[24] Broadly speaking, the rate base is the investment, determined chiefly by reference to original cost, cost of reproduction, and depreciation, on which a regulatory agency believes that a public utility should be allowed to earn a "fair return" if such a return can be earned without charging what the agency regards as unreasonable rates for the utility's services. Whether market value exceeds, falls short of, or equals the rate base depends upon a variety of circumstances—the strength of the demand for the various services offered by the utility, the willingness of the regulatory body to allow the utility to charge all the traffic will bear when demand for some services is so weak that the burden must be concentrated on a few services or absorbed by the owners, and the necessity of keeping rates of competing utilities on a par even though they may mean excessive returns on the rate base of the more favorably situated.

This analysis leads to the conclusion that any similarity between the physically depreciated cost and the market value of railroad property, though not purely coincidental, is largely so. Presumably, then, railroad assessors should give cost only such consideration as is necessary to satisfy the courts and to allow for the fact that value for rate-making purposes is determined with principal reference to original and reproduction cost. Depreciated reproduction cost need not be given any standard weight in appraisals made by formula,[25] and clearly should not be used as virtually the sole evidence of value (aside from last year's assessments), as is the practice in States with local assessment and in eight of the central assessment States. It is believed that cost factors should ex-

[24] Bonbright, *op. cit.*, p. 13.

[25] The use of cost in a railroad appraisal formula was sanctioned by the U.S. District Court, Eastern District of Washington, in the case of *Northern Pacific Ry.* v. *Adams County* (1932) 1 Fed. Supp. 163. For two of the three railroads involved, the court allowed a weight of one for cost, and weights of two each for stock and bond values and capitalized earnings. (The third railroad had no listed securities, so a weight of four was given to capitalized earnings.) This so-called 20–40–40 formula has been found acceptable in subsequent cases (*Bailey* v. *Megan,* [1939] 102 Fed. [2d] 651, and *Grand Trunk Western Ry. Co.* v. *Brown,* [1940] 32 Fed. Supp. 784) and is now used with some modifications in several States. However, it is clear that the appraisal need not be made by formula (*Chicago, Burlington, & Quincy R. R.* v. *Babcock,* [1907] 204 U.S. 585, 593), and it seems unlikely that a formula which gave no weight to depreciated cost would be held arbitrary by the courts unless it produced an assessment above the depreciated reproduction costs or unless it appeared that the accessors had not only failed to give weight to cost factors but had failed to consider giving them weight.

ercise their principal influence upon the appraisal of railroad property indirectly rather than as independent evidences of value.

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RONALD B. WELCH

The Northwest Airlines Case

INTERESTING special problems of public utility taxation and the general problem of territorial apportionment are observed in the field of airline taxation. The matter was brought sharply to public attention in a Supreme Court decision discussed below by Ronald B. Welch.*

It is said that fools rush in where angels fear to tread. Perhaps this is the reason that the discussion of the case of *Northwest Airlines* v. *Minnesota* [1] was assigned to me rather than to a lawyer. An angel could not be expected to criticize God very severely, and a lawyer might feel some ethical or professional compunction about criticizing the Supreme Court. But as an economist, I can speak with only such restraints as are imposed upon me by a reasonably full knowledge of the facts and a layman's knowledge of the law. Of course what I have to say is all in good fun and reflects no animosity toward any of the participants in the litigation.

In brief, it is my thesis that the majority of the Supreme Court, in its zeal to sustain the taxing powers of the states, has either deprived the commerce clause of much of its meaning in tax matters by authorizing double taxation of the instrumentalities of interstate commerce or betrayed its own cause by fostering a rule of tax situs which will result in virtual property tax immunity for the equipment of the airlines and of many members of the older carrier groups.

For the benefit of those not familiar with the case, let me state very briefly the essential facts. Northwest Airlines is a common carrier which, in 1939, operated a fleet of 14 line-service planes between Chicago and the West Coast. At that time it made scheduled stops in seven states and operated routes which traversed an eighth state. According to the agreed statement of facts, all seven of the states in which stops were made taxed some part of the fleet, three of them under laws providing for state

[1] 322 U.S. 292, decided May 15, 1944.

* *1944 Proceedings,* National Tax Association, pp. 285–291.

assessment of an allocated portion of the fleet and the other four under general property tax laws making no explicit provision for the taxation of planes.

Minnesota, which accounted for 14 per cent of the route mileage and 16 per cent of the scheduled plane mileage on May 1, 1939, was one of the four states in the latter group. It had the distinction, however, of having chartered the company and having within its boundaries the company's home office and principal repair base. The taxpayer filed a 1939 personal property tax return with the Ramsey County assessor at St. Paul, in which it listed only that part of its fleet which was in Minnesota on May 1, the Minnesota assessment date. However, the assessment was increased by the Ramsey County authorities to cover the entire fleet. In a suit to collect the tax, the trial court sustained the taxing authorities, and this judgment was affirmed in turn by the State Supreme Court [2] and the United States Supreme Court.

The prevailing opinion of the United States Supreme Court was written by Mr. Justice Frankfurter, subscribed to by Justices Douglas and Murphy, and concurred in with separate opinions by Justices Black and Jackson. Chief Justice Stone wrote a dissenting opinion in which Justices Roberts, Reed, and Rutledge joined. Thus we have the phenomenon of a decisive opinion to which only three justices gave unqualified approval and a dissenting opinion which elicited more support than any one of the four opinions required to dispose of the case. The Minnesota Supreme Court was almost as badly divided, with a majority opinion, a concurring opinion, and a dissent. All in all, it would be difficult to find a tax case on which there has been as little agreement within the ranks of the judiciary. It is a pleasure for one who comes from a profession plagued with a reputation for dissension to record this lack of unanimity on an issue which could be amicably disposed of by the tax economists any afternoon between four and six.

The prevailing opinion of the United States Supreme Court opens its argument with the observation that the tax was assessed under a general tax law applicable to the personal property of resident persons, including corporations, that all of the planes were in the state at one time or another during the year, and that the corporation domicile, the principal place of business, and the "home port" of the planes were within the state. On the basis of these observations, the case is held to be clearly ruled by *New York Central Railroad* v. *Miller.*[3]

Why the Court should have selected this case as the controlling precedent rather than the car-line cases which stem from *Pullman's Palace Car Co.* v. *Pennsylvania* [4] is an interesting question. It is true that this was one of the scant half dozen Supreme Court decisions on the powers of a *domiciliary* State to tax the equipment of an interstate

[2] 213 Minn. 395, 7 N.W. (2d) 691 (1942).

[3] 202 U.S. 584 (1906).

[4] 141 U.S. 18 (1891). The direct descendants of this case include *American Refrigerator Transit Co.* v. *Hall,* 174 U.S. 70, (1899), *Union Refrigerator Transit Co.* v. *Lynch,* 177 U.S. 149 (1900), *Union Transit Co.* v. *Kentucky,* 199 U.S. 194 (1905), *Union Tank Line Co.* v. *Wright,* 249 U.S. 275 (1919), and *Johnson Oil Co.* v. *Oklahoma,* 290 U.S. 158 (1933).

carrier.[5] But Mr. Justice Frankfurter could as well have chosen his text from *Union Transit Co.* v. *Kentucky,* as did Chief Justice Stone in his admirable dissenting opinion. However, the *New York Central* opinion was written by the celebrated Mr. Holmes, while the *Union Transit Company* opinion was written by an obscure justice who had mounted the bench without benefit of a Harvard education.

Limitations of time preclude an extended discussion of the Supreme Court cases on the tax situs of carrier equipment units. Suffice it to say that I have always regarded the *New York Central* and *Union Transit Company* opinions incompatible[6] and that I find the *Northwest Airlines* and *Union Transit Company* opinions completely beyond reconciliation. In the *Union Transit Company* case it was assumed for lack of a contrary showing that some of the taxpayer's refrigerator cars never entered Kentucky, the domiciliary state, during the tax year and were therefore "permanently located in other states." But there was neither a showing nor an implication that any one car spent the whole of the tax year in any one state. Now, however, Mr. Justice Frankfurter says that "the situs which personal property may acquire for tax purposes in a state other than that of the owner's domicile cannot be made to depend on some undefined concept of 'permanence' short of a tax year. . . ." This statement indicates that Mr. Frankfurter, and possibly some of his colleagues, believe that all equipment units of transportation companies should be divided into two groups. First, there are those equipment units which never cross a state line during the tax year; these units are taxable in the state of physical situs. All other equipment units are taxable in the "home" state. Under this doctrine, there is no room for the allocation technique in the assessment of equipment; any given unit is taxable on its full value in one state and in no other.[7] This position is definitely contrary to the holdings in every one of the car-line company cases despite the gesture of reconciliation which is made in the prevailing opinion.

The fact that many of the states have adopted the allocation techniques explicitly sanctioned by these car-line company decisions and im-

[5] The other cases are *Transporation Co.* v. *Wheeling,* 99 U.S. 273 (1878); *Union Transit Co.* v. *Kentucky,* 199 U.S. 194 (1905); *Southern Pacific Co.* v. *Kentucky,* 222 U.S. 63 (1911); and *Chattanooga & St. Louis Railway* v. *Browning,* 310 U.S. 362 (1940).

[6] It is significant in this connection that Mr. Holmes dissented in the *Union Transit Company* case. Mr. Justice Brown, who wrote the majority opinion in the latter case, did not dissent in the *New York Central* case, but the fact that he retired from the bench on the very day that the decision was announced suggests that he may not have participated vigorously in the settlement of the case.

[7] The notion seems to exist in certain quarters that it is unconstitutional for a state to tax a fractional part of an equipment unit. A fleet of 5 buses operating equally in two states could not be divided into two equal parts according to this philosophy; each state would have to tax either two or three buses, not 2½ buses. A different but related notion would deny a state the right to tax any part of a fleet unless at least one member of the fleet was in the state at all times. (If Mr. Holmes' curious reference to an "average of cars . . . so continuously in any other state as to be taxable there," echoed by Mr. Frankfurter in footnote 4 of his opinion, means anything—which I sometimes doubt—it must mean that at least one car is always in the state.) Neither of these notions appears to be particularly logical.

plicitly sanctioned by a host of decisions involving railroad taxes is completely ignored by the majority opinion in *Northwest Airlines v. Minnesota*. Indeed, Mr. Justice Frankfurter displays almost inexcusable ignorance of property tax institutions by stating that "the doctrine of apportionment has neither in theory nor in practice been applied to tax units of interstate commerce visiting for fractional periods of the taxing year." Later he says, "To introduce a new doctrine of tax apportionment as a limitation upon the hitherto established taxing power of the home state is not merely to indulge in constitutional innovation. It is to introduce practical dislocation into the established taxing systems of the states." It may well be that a holding against Minnesota would have disturbed a few existing relationships between the states and their domestic carriers, especially if the opinion had been so general that it could be extended to private motor and water carriers. But every state is a non-domiciliary state to some of the carriers operating across its boundaries, and Mr. Justice Frankfurter's opinion rides roughshod over established relationships in this quarter if one is to take seriously its condemnation of apportionment.[8] There are already 10 states[9] which apportion the fleets of the airlines, 12 states[10] which apportion the fleets of some motor carriers, 36[11] which apportion the fleets of the passenger or freight-car-lines, 39[12] which apportion the rolling stock of railroads, and even one (Virginia) which apportions the floating equipment of certain water carriers.

One cannot tell from the prevailing opinion what would have been the decision had Northwest Airlines been incorporated in some other state than Minnesota, say in Delaware. Mr. Justice Jackson makes it clear in his concurring opinion that he does not think the state of incorporation should acquire tax jurisdiction unless it serves as the commercial domicile—the operational headquarters—as well as the corporate domicile. With this conclusion I cannot quarrel, although I reach it from the premise that domiciliary tax situs means tax exemption rather than from any speculation over the amount of benefits which a domiciliary state affords its corporations. As long as we have three states, one of them with the most liberal corporation laws in the country, which tax no personal property, taxation of transportation equipment in the state of domicile is bound to degenerate into tax exemption.

But where I take issue with Mr. Justice Jackson is in his statement that "the apportionment theory is a mongrel one," a "rather illogical de-

[8] The dissenting opinion takes no cognizance of this condemnation and states flatly that "the rationale found necessary [by the majority] to support the present tax leaves other states free to impose comparable taxes on the same property . . . which Minnesota has already taxed . . . at its full value." The prevailing opinion, it is true, did not pass upon the validity of taxes levied in states other than Minnesota, but it carefully built the scaffold on which to hang such taxes should they be litigated.

[9] Kentucky, Louisiana, Maryland, Nevada, North Dakota, Oregon, Utah, Washington, West Virginia, and Wyoming.

[10] Arkansas, Kansas, Kentucky, Louisiana, Maryland, Nebraska, Nevada, Tennessee, Utah, Virginia, Washington, and West Virginia.

[11] *Tax Systems of the World* (9th ed.), pp. 277–83.

[12] All States except Connecticut, Delaware, Maine, Massachusetts, Minnesota, New Jersey, New York, Pennsylvania, and Rhode Island.

vice" with nothing either in theory or in practice to commend it for transfer to air commerce. I think it is a self-evident truth requiring assertion rather than proof that the apportionment theory is a thoroughly logical device. True, it has led to a little overlapping taxation; it has put the transportation agencies and the states to some expense to compile allocation data; and it has occasioned some duplication of effort by the states in the making of unit appraisals. But these are small entries on the debit side of the ledger as compared with the credit entries representing the benefits of greater justice to bridge states and the prevention of wholesale tax avoidance and evasion by location of "home ports" in states declining to tax personal property or in localities whose officials are willing to wink at the tax law in order to lure a home office away from another state. What Mr. Justice Jackson does not realize, I suspect, is that the home offices of transportation companies are only slightly less footloose and fancy free than their corporate charters. Minnesota is aware of this fact, for Northwest Airlines, I am told, has already announced its intention of departing the state if the property tax laws are not amended. I see no good reason why Northwest Airlines could not move its home office to Oregon or Washington—states whose laws now call for allocation of airline properties and which would probably not change these laws if the golden goose were to nest within their boundaries. Nor do I see why United Airlines should refrain from moving its headquarters from Chicago to New York if Cook County should suddenly assert its rights, under Mr. Justice Jackson's theory, to tax the whole fleet while New York continues to exempt all personal property.

Mr. Justice Black, in a rather obscure concurring opinion, appears to doubt that the commerce clause bars taxation of a given item of property in more than one state under all circumstances. He then "plugs" his familiar thesis that Congress should define the limits of state taxing power over the instrumentalities of interstate commerce. Mr. Justice Jackson's opinion may also be said to invite Congressional action by holding that Congress can constitutionally free airplanes from any and all state and local taxation if it is so minded. Although I doubt that Congressional authority is as broad as Mr. Jackson would have us believe, I subscribe to the proposition that Congressional silence on this subject is becoming intolerable.

What Congress should say as to the powers of the states to tax the instrumentalities of interstate commerce is a challenging question. Our experience with federal limitations upon state taxation of national banks has not been a happy one. However, if agreement can be reached as to the objectives, I am enough of an optimist to believe that an acceptable statute can be framed. In this belief, I have set down a few objectives with which I will conclude this paper.

1. The states should be free to tax carriers operating in interstate commerce in any manner which does not substantially discriminate in favor of similar carriers engaged wholly in intrastate commerce.
2. The tax situs of the equipment units of private and for-hire carriers which are not operat-

ing under authority of a federal regulatory agency should be in the state in which such units are headquartered.[13] This rule of situs should be controlling for property tax purposes and in the allocation of capital stock and net income for corporation tax purposes.

3. All other carriers which operate both within and without the taxing state should be taxable by the state upon property, gross earnings, net income, and capital stock tax bases only if the bases are apportioned in such manner that they fairly reflect the extent to which the property and business of the carrier are within the state during the tax year.
4. Precise control of apportionment methods should not be attempted by federal statute, but neither should the Congress refuse to give any guidance to the courts or to whatever administrative body might be given quasi-judicial authority in this field. Two questions which the Congress might appropriately answer are these:
   a. Should a state in which no pick-ups and deliveries are made have jurisdiction to tax carrier equipment units? This is a particularly moot question in the field of air transportation although much the same issues are involved in water transportation.
   b. Are domestic carriers which travel over or on the high seas to be immune from taxation on some fraction of their property and/or business?

These problems as they relate to air carriers are presently the subject of an investigation by the Civil Aeronautics Board. It is probably well that the proposed solutions will be first applied to a small segment of the national transportation system on which the states rely for a wholly insignificant part of their revenues. But if at all possible, the proposals should be designed for easy adaptation to other transportation agencies to the end that all carriers will fare equally at the hands of the tax collector and the twin specters of exemption and multiple taxation will be banished from the land.

[13] This proposal would seriously disturb state policies with respect to property taxation of car-line companies. Unless and until such companies are brought under federal regulation, an appropriate modification of the rule stated in the text should be made. The rule would also preclude allocation of the fleets of certain motor and water carriers, but it is believed that state tax policies will be less disturbed if the rule is allowed to prevail in these areas than if these carriers are brought within the scope of the third proposal before they are subjected to federal regulation.

JOINT COMMITTEE*

Report on Bank Taxation

THE taxation of banks raises special problems mainly because banks are instrumentalities that the federal government seeks to control. State powers to tax national banks have thus been subject to federal statute (Section 5219). In the selection presented below, committees of the National Tax and the American Bankers associations consider the present status of state taxation of banks and make certain recommendations jointly.

What is now U.S.R.S. Section 5219 was first enacted in 1864. It was amended in 1868, in 1923 and again in 1926. Although there has been much agitation since 1926 for further amendment, no change in the statute has been made since.

The provisions of Section 5219 in their present form authorize, in addition to the taxation of the real property of national banks, the use of any one of four taxing methods, with the combination of two of them upon certain conditions. These methods are:

1. An *ad valorem* tax on the shares, at no greater rate than imposed upon other competing moneyed capital;
2. Taxation of the dividends from the shares as part of the taxable income of the owners or holders, at no greater rate than the income from other moneyed capital;
3. Taxation of the bank on its net income (excluding that from tax-exempt securities) at no higher rate than that upon other financial corporations nor higher than the highest of the rates upon mercantile, manufacturing and business corporations;
4. Taxation of the bank according to or measured by its entire net income from all sources (including tax-exempt securities) with the same comparative limitations as under (3).

Whenever corporations generally are subject to an income, franchise or excise tax the taxing state may also include the dividends of national banks in the taxation of the income of individuals if the dividends of other corporations are likewise taxed.

From 1864 to 1923 the *ad valorem* share tax was the only method of taxing national banks authorized, and that method is still used in

* "Joint Report of Committees of the National Tax Association and American Bankers Association Upon Proposed Changes in U.S.R.S. Section 5219," *1942 Proceedings*, National Tax Association, pp. 200–208.

thirty of the states, although more than half of them have adopted the classified intangible property tax at a low rate in place of the general property tax. Of the states which have retained the first, or share tax method, the following fourteen still subject shares of national banks to the general property tax: Arizona, Arkansas, Georgia, Illinois, Louisiana, Mississippi, Missouri, Montana, New Mexico, North Carolina, Tennessee, Texas, West Virginia and Wyoming. The following sixteen states subject national bank shares to a tax at the special fixed rate applied to all other moneyed capital: Delaware, Florida, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Nebraska, Nevada, New Hampshire, New Jersey, Ohio, Pennsylvania, Rhode Island, Virginia.

Since 1923, when other methods of taxing national banks were first authorized, seventeen states have adopted one or another of such methods.

One state, Vermont, has adopted the second or dividend method exclusively, and one other state, Michigan, has adopted the dividend method with maximum and minimum limits based on the par value of the shares.

Two states, South Carolina and Wisconsin, have adopted the third or income method of taxing national banks.

Thirteen states have adopted the fourth or excise method, namely, Alabama, California, Colorado, Connecticut, Idaho, Massachusetts, Minnesota, New York, North Dakota, Oklahoma, Oregon, South Dakota and Utah.

The remaining state, Washington, does not tax intangibles or income, and consequently does not tax the shares, income or dividends of national banks by any method.

Most of the states which have adopted the income or excise methods of taxing national banks also levy personal income taxes and include the dividends of national banks received by residents of the state in the taxable income of such residents.

Since 1926 there have been changes in the methods of taxation commonly used by the states, changes in the attitude of the Supreme Court of the United States toward implied intergovernmental immunities from taxation, and the introduction of forms of taxation under the so-called "fourth method" authorized in 1926, which, it is believed, are not in accordance with the intent of Congress, and it is felt that amendments in several matters of substance should be adopted by Congress if Section 5219 is to function in a satisfactory manner.

Moreover, when the earlier amendments were adopted, in the fear of causing changes where none were desired, the language of the section was not modified sufficiently to make it conform to the amendments. As a result there are places where the words of the statute conflict, and others in which the arrangement is unnecessarily confusing. If further amendments of substance are to be made, the phraseology and arrangement of the statute should be considerably modified. At the same time care should be taken not to alter the wording of particular provisions that have received interpretation from the Supreme Court, when no change of meaning is intended.

The amendments with respect to substance, some of which are of a clarifying or interpretative nature,

which we recommend, are as follows:

1. It should be made clear that the forms of taxation of national banks which are authorized by Section 5219 are the only forms of taxation which a state may impose upon such institutions. For a long time after the doctrine of implied intergovernmental immunities from taxation had been established it was looked upon as absolute in itself, and even in the absence of any statute granting exemption, it was held that neither the federal government nor a state could tax the instrumentalities of the other, although no discrimination was shown and no impairment of the power of the instrumentality taxed to carry out the functions for which it was established.

Farmers' & Mechanics' Savings Bank v. *Minnesota,* 232 U.S. 516, 525, 526.
Johnson v. *Maryland,* 254 U.S. 51, 55, 56.

While this principle was in force, it followed that but for Section 5219 no state could tax national banks at all and that taxation of national banks by the states could not be valid unless imposed in such a way as to come within the authority granted by Congress.

Owensboro National Bank v. *Owensboro,* 173 U.S. 664, 668.
Bank of California v. *Richardson,* 248 U.S. 476.

Under the principle more recently established by the Supreme Court it is still recognized that Congress may by statute exempt federal instrumentalities from taxation by the states.

Pittman v. *Home Owners Loan Corporation,* 308 U.S. 21, 33.
Federal Land Bank v. *Bismark Lumber Co.,* 314 U.S. 95, 102.

It has, however, been held that when Congress has been silent on the question of the exemption of a federal instrumentality from state taxation, no exemption will be implied simply from the relations of the federal government and the states under the Constitution, and a state may tax an instrumentality of the federal government in the form of a private individual, a private corporation or private property unless the tax discriminates against the federal instrumentality or it can be demonstrated that the tax will impair the ability of the instrumentality to perform the federal service for which the federal government intended to use it.

Metcalf v. *Mitchell,* 269 U.S. 514, 526.
Graves v. *O'Keefe,* 306 U.S. 466, 477, 478.
Alabama v. *King,* 314 U.S. 1, 8.

It is probable that Section 5219 in its present form, in which it authorizes the taxation of national banks by certain specified methods and subject to carefully drawn limitations, would be construed to impliedly prohibit the taxation of such banks by other methods and with no limitations except those derived from the Constitution, but it would be wise to include in the statute a specific statement that the methods of taxation authorized by the statute are exclusive of all others.

2. It should be made clear that the tax on national banks "according to or measured by their net income," which constitutes the "fourth method" authorized by Section 5219, is an excise tax upon the banks, by inserting the words "impose an excise tax upon such associations" at the beginning of clause (4) in the first paragraph of Section 5219 as it now stands.

There are two reasons for this proposed amendment. In the first place the statute in its present form is rather puzzling to those not thoroughly familiar with the intricacies of taxation and leaves them in doubt as to the sort of tax intended by the "fourth method" and uncertain wherein it differs from the third or income tax method. The inserted words clarify the statute. The "fourth method" might have been used more frequently in the past few years if these words had been in the statute from the time that the "fourth method" was authorized. To many legislators the "fourth method" seemed merely another form of income tax, and in some states income taxes were not permitted by the state constitution or encountered strong hostile prejudice.

In the second place the Supreme Court of the United States, in *Tradesmens National Bank* v. *Oklahoma Tax Commission*, 309 U.S. 560, decided March 25, 1940, referred to the tax under the "fourth method" as a franchise tax. There are dangerous possibilities in the suggestion that the franchise of a national bank might be subjected to taxation by the states. It is probable that the court did not intend to give any different interpretation to the statute than that which it had previously received; but it seems wise to set any uncertainty in the law at rest.

3. The income tax or the excise tax upon national banks authorized in clauses (3) and (4) of the first paragraph of the present statute should be uniform throughout the state. It has always been the generally accepted view that it was the intent of Congress that such taxes should be imposed at the same rate throughout the state. This conclusion follows from the provision of paragraph 1 (c) of Section 5219 in its present form that the rate of taxation in the case of a tax imposed by a state on national banks on or measured by net income shall not be higher than the highest of the rates assessed upon certain other corporations "doing business within its limits"—that is, within the limits of the state imposing the tax. Such a comparison would not be capable of equitable application except in case of a uniform state-wide tax both on banks and on the other classes of corporations.

Since the development of the modern income tax system it has been the uniform practice in states in which general income taxes have been levied to impose the tax with geographical uniformity throughout the state. There have recently been suggestions of a plan to super-impose on the existing state income or excise tax a municipal income or excise tax on banks in certain cities within a state only, or within a single city. It is apparent that such a tax would create an undesirable discrimination among the banks of different cities in the same state. It would be equally undesirable if cities were allowed to bid against each other for the location of national banks by offering reductions in the rate of income taxation.

The adoption of the income and excise methods of taxing national banks was due in part to a desire to avoid one of the evils which had arisen in the general property tax states, namely the difference in the burden in the different taxing subdivisions of the state due to the different tax rates, which led to the creation of certain favored districts.

This evil was so great that New York, in 1901, while it still adhered to the share tax method, established a uniform rate throughout the State. More than half of the other states which still retain the share tax method have adopted a rate for taxing bank shares uniform throughout the state. It would be a step backward to permit the introduction of the practice leading to one of the great evils of general property taxation into income and excise taxation. An invitation to lack of uniformity in income taxation should be definitely discouraged, especially in the case of banks, which hold such a substantial part of the financial resources of the community. It is believed that the attempt to achieve such a result should be rendered impossible by unequivocal language in the statute.

4. The rate of income or excise tax imposed upon national banks should not exceed the rate of tax of like character upon the other financial corporations or the business corporations of the state.

In Massachusetts, which was one of the states which first adopted the excise method of taxing national banks, the excise on the business corporations was measured only in part by income and the rate applied to the banks was established by determining the proportion of income of all business corporations absorbed by the entire excise; and an opportunity was afforded to the banks to verify the rate.

In one or more of the other states which tax national banks and other corporations by the excise tax method but which levy on the other corporations an excise measured by income only, an excise has been imposed upon banks measured by net income from all sources at a rate computed by determining the ratio of the aggregate of taxes of all kinds paid by business corporations (except taxes on real estate) to the aggregate of the net income of such corporations and using this ratio as the rate to be applied to the income of banks. The validity of this tax is supported by the contention that "rate" means "burden," and this contention is in a measure given encouragement by the decision of the Supreme Court of the United States in *Tradesmens National Bank* v. *Oklahoma Tax Commission,* 309 U.S. 560, rendered March 25, 1940, to the effect that an excise tax on national banks is not in violation of Section 5219 if, taking into consideration all of the taxes on business corporations, no discrimination against national banks is shown.

There are serious practical objections to an excise tax measured by income at a rate thus determined. In the first place, no opportunity is afforded to the banks to verify the accuracy of the state officials in determining the ratio, which indeed may be incapable of verification until long after the tax has been assessed upon and paid by the banks. The selection of the classes of corporations to be included in the comparison or the definition of real estate for purposes of taxation may have a substantial effect on the rate of tax to be applied to banks. The rate is thus established each year largely upon the estimate of the state taxing officials with respect to figures and amounts, and their decisions upon difficult points of law. It is doubtful if such officials can ever determine a rate that will not be open to successful attack on the ground of failure to comply with the state law;

at best such a method of taxation is provocative of constant litigation.

In the second place, the rate is based upon a wholly inappropriate comparison. Ad valorem taxation bears no relation to income and may be the same if there is no income. The aggregate of ad valorem taxes does not vary widely from year to year. In a year of business prosperity the aggregate of ad valorem taxes paid by business corporations may constitute a small proportion of their income; whereas in a year of business depression the number of business corporations operating at a loss may be so great that the aggregate of the ad valorem taxes paid by business corporations exceeds the aggregate of the net income of such corporations. In such a year the rate of tax measured by the net income of the banks might equal or exceed one hundred per cent. It is true that such of the states as have adopted this method of taxing national banks have established a maximum rate; but if this method of determining the rate is authorized by Section 5219 there is no obligation upon the states to establish a maximum limit.

While from the standpoint of good banking practice the net income methods are preferable to ad valorem taxation, even when ad valorem taxation is in the form of the low-rate intangible tax, the rate of tax applicable to net income, if not controlled, may well result in the absorption of so much of the earnings of national banks as to deter investment in the shares and to reduce additions to surplus. This is especially true in this era of low money rates which has created a situation that has been facing the banks for some time and is likely to continue.

In the third place, so far as the intent of Congress can be inferred from the legislative history of the act authorizing the taxation of banks by the excise method, it would seem that a comparison with anything but other excise taxes was not contemplated. Such an inference follows from the report of the Committee on Banking and Currency of the House of Representatives to the House in 1926 when it reported the bill which authorized the "fourth method" of taxing national banks. The following is an excerpt from the next to the last paragraph of that report:

> The language of the pending bill is broad enough to permit a State that imposes corporate excise or franchise taxes, which are not based on income, to apply the net income method to national banking associations, provided the burden of tax is no higher than that imposed upon other corporations generally under such excise or franchise tax.

In the fourth place, it should be remembered that, although authority for determining the rate of excise taxation on banks in a manner similar to that now under discussion was included in some of the bills for the amendment of Section 5219 introduced into Congress in the years subsequent to 1929, none of the bills was enacted, although safeguards for the protection of the banks were thrown around the method of determining the rate in all of these bills.

The comparison therefore ought to be limited to taxes of like character; that is, an income tax on banks should be imposed at a rate not exceeding the rate of income tax imposed on other corporations; and an excise tax on banks should be imposed at a rate not exceeding the rate

of excise tax imposed on other corporations. Such a limitation would not preclude the inclusion of all elements entering into the excise tax on the other corporations; but the proceeds of such a tax in relation to income would not vary widely from year to year, it would be capable of precise ascertainment and verification, and would not afford the opportunities of abuse which are open when taxes of all kinds may be considered without an adequate right of verification by the banks.

5. There should be a minimum tax in states employing the income or excise methods, applicable to banks having no taxable income but continuing to pay dividends.

Many banks, by charging off bad debts and losses arising from securities becoming worthless, have no taxable income, and pay no tax, sometimes over a series of years; but during such years have an operating income and continue to pay dividends. We believe that such banks should pay a minimum tax of some sort, but we do not approve of a minimum tax on all banks measured by capital, whether based on issued capital stock or on net worth, because one of the main objects of putting the taxation of national banks on an income basis is to avoid taxation of the capital of the banks.

We consider that a minimum tax on banks which are taxed by the income or excise method, of an amount equal to one per cent of the dividends declared in the preceding year, would cure the evil of total exemption which has been the subject of concern by the taxing authorities in a number of states, without imposing any unfair burden on the national banks.

6. In 1926, when the last amendment to Section 5219 was adopted, permitting the fourth, or excise, method of taxation, general sales and use taxes were almost unknown in state legislation, and the selective sales taxes then in force were not applicable to fiscal activities, such as banking.

In the last ten years about half of the states have adopted general sales taxes, often complemented by use taxes, imposed upon the buyers (or users) of tangible personal property. Some of the larger cities in the other states have also imposed such taxes. It seems clear that under Section 5219 such taxes can not be imposed upon national banks, and it has caused some irritation among taxing officials to find that national banks, when they purchase stationery, furniture, equipment and supplies for their banking rooms and offices, are not subject to sales taxes; and even more irritation when a national bank, which by virtue of the foreclosure of a mortgage owns and operates an office building or an apartment house or is otherwise engaged in a business in competition with private investors or business men, is able to claim exemption from sales taxes on coal, oil, equipment and supplies used in connection with such business.

Usually the amount involved is not large ($2,000 to $5,000 annually in the case of the larger banks in cities other than New York) and some national banks have paid the taxes rather than stir up trouble and ill will. Such a course of action might however subject the bank to criticism by the bank examiners, especially when the attorney-general of the state has ruled that the tax cannot be enforced against national

banks, or might even render the directors of the bank liable to suit by a stockholder.

There are also some selective sales taxes now in force in all, or almost all, of the states, which are to some extent applicable to banks, such as the gasoline tax, but which could not be collected from national banks if the banks insisted upon their rights. In some states the taxes on the sale or use of tangible personal property are supplemented by taxes on the sale of public utility services, such as the supply of gas, electricity or water, or the use of the telephone, which are not but should be applicable to banks.

It is therefore in our opinion wise to add a new paragraph to Section 5219 authorizing the subjection of national banks to nondiscriminatory sales and use taxes, and to taxes upon payments for services.

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EDWARD L. SCHEUFLER

Insurance Taxation in the State Economy

ALTHOUGH insurance companies are similar to banks in some respects, the taxation of the former provides quite a different problem from that of the latter. The following selection * discusses the present position of state taxation of insurance companies.

I

History and Extent of Insurance as the Subject of Taxation

In this brief panorama of "insurance taxation in the state economy," suggestive in nature for brevity, purporting only to cover certain factual aspects (the development of the case law is left to others), we find that the insurance business as a subject of taxation has grown tremendously since its approximate beginnings in 1819 in Connecticut and 1824 in New York. A special tax of 10% on premiums collected within the State on foreign fire insurance companies was then levied by the State of New York. Other states followed the example, most of them using gross premiums as a basis for the tax; the rate of taxation varied by states and was generally much lower than under the original New York law. Today, a great majority of the states exact approximately 2% of the premiums received on business done within the respective states, with

* *1944 Proceedings,* National Tax Association, pp. 113–120.

varying credits for dividends, canceled and returned premiums, etc.

Historically, in the year 1800, less than one hundred life insurance policies existed in the United States; whereas, at the outbreak of the Civil War, life companies reported to the State of New York alone, total annual premiums of $4,700,000, covering 56,000 policies, representing insurance in force of $136,000,000 and company assets of $24,000,000.

Presently, there are approximately 65,000,000 life policyholders in the United States, having insurance in force in the amount of $152,463,577,050 (1943), with total admitted company assets, for 96% of the business, of $41,313,605,747 (1943). In 1943 the premium income from 96% of the life insurance companies was $4,659,413,778. To this can be added the tremendous impact of fire, casualty, marine, surety, and other miscellaneous coverages.

Insurance companies paid to the general revenue funds of the various states for 1942 total taxes of over $113,000,000, of which over $100,000,000 was paid by premium taxes.

As a typical instance, consider the State of Missouri, which ranks tenth in population and tenth or better insurance-wise. With a population of three and three-quarters millions in 1943, its citizens maintained $4,250,000,000 in life insurance alone, in force on 4,750,000 policies, resulting in premiums of $180,000,000 on life coverage alone, exclusive of annuities. The State received approximately $3,500,000 in premium taxes from all kinds of insurance. Life insurance accounted for approximately 60% of the total, fire insurance about 17%, and the balance, 23%, casualty and miscellaneous lines.

II

Distinguishing Aspects of Insurance as a Subject of Taxation

The nature of the insurance business early drew an analogy, not only as to taxation, but also as to regulation, to the banking business of the country. To some extent, the mitigating influence of this early classification determined the comparative tax burden on insurance companies.

Also, by reason of its nature and the requirements of safety involved, the assets and the income of insurance companies are earmarked to a considerable degree as reserves and property, which do not belong to the company assets but which are, in effect, held in trust for the benefit of the policyholders.

Following upon the affirmance in 1869 of exclusive state regulation by the Supreme Court decision in the famous case of *Paul* v. *Virginia,* 4 Wall. 168, the states broadened their insurance codes. Taxation was invoked more fully to strengthen the administrative control and regulation of the business. Considerable emphasis was given to improved control by the so-called Hughes investigation, conducted by the Armstrong Committee of the New York Legislature early in this century. It is interesting to note that the original National Banking Act grouped insurance companies as "competitors" of national banks and accorded them the tax privileges of the banks; thus, gradually the great public interest and security involved led the various state legislatures to consider insurance as analogous in this respect with the business of banking in general in imposing taxes on the insurance business.

III

Factors Impelling the States to Tax Insurance Companies

Motivating factors, upon brief observation, have been varying. In most states, the production of income has been a secondary consideration in levying taxes upon insurance companies. As illustrated, supra, an original factor leading to their taxation was in the nature of retaliation upon the position of the State of New York 120 years ago. Collaterally, the necessity of regulation by the state, with its attendant costs, the propulsion of new enterprise, retaliation, and in some states encouragement of domestic insurance companies have led to various insurance tax enactments. Many states tax companies of other states upon premium income only, and some of these states have only a property tax upon certain classes of local companies.

Connecticut, one of the states which do not use the so-called premium tax method, taxes domestic stock companies on the market value of outstanding stock and domestic mutual companies by franchise tax of the interest, dividends, rents and other income received by the company (exclusive of income from real estate taxed in the state). However, here also the tax is measured by premium income collected. Foreign companies are subject to the provisions of retaliatory legislation.

IV

Methods of Taxing the Insurance Companies

Here are the general methods of taxing insurance companies, their assets, or business:

1. *Premium Tax Method*

The "premium tax" method is used by practically all of the states with the exception of Connecticut and Massachusetts. Under this method the state taxing statute usually provides, in substance, that insurance companies of other states shall pay an annual tax either upon or measured by the premiums received on account of business done within the state at the rate of __% per annum, in lieu of other taxes (with varied exceptions); and provides further that fire and casualty companies be credited with canceled or returned premiums, that life insurance companies be credited with dividends, and that, in some instances, various types of companies be credited with premiums paid for reinsurance. Premium taxes paid by all classes of companies to all the various states of the Union in 1940 totaled approximately $105,000,000. Although the premium tax method has variations state-wise, depending on the rate and deductions allowed, it seems to be the most workable method from the standpoint of assessment and collection, considering the distinguishing aspects of the insurance business.

2. *Market Value Taxation*

This method appears to have originated in the only state employing it (Connecticut) in the year 1819 when the taxing statute of that state provided for placing various articles on the tax list as follows: dwelling houses and lots, 2%, other lands, 3%, mills, stores, distilleries and manufactories, 3%; horses, asses and mules, 8%; stallions at $67; neet cattle, 6%; silver plate, 50%; turnpike stock netting 6% at 6%;

coaches, 40%; other carriages, 30%; clocks, watches, and timepieces, 50%; *and bank and insurance stock at 6% of their value.*

This early statute went on to place the stock of domestic insurance companies and banks in two groups; the first being that owned by residents of the state and subject to taxation by the town where the owner resided, and the second group being composed of stock belonging to non-residents of the state with the tax going into the state treasury. By subsequent enactment, the Connecticut tax on domestic banks and stock insurance companies is paid directly to the State for state usage.

3. *Taxation of Investment Income*

This tax is imposed by the State of Connecticut on mutual life insurance companies and by the Federal Government on all life insurance companies. It is a type of net income tax, taking into consideration the nature of the income of legal reserve life insurance companies, which income consists of premium receipts on the one hand and earnings by way of interest, dividends, and rents on the other. In the State of Connecticut, the tax is 3% on the investment income, less rents on real estate owned in Connecticut and less the income from Federal and Connecticut state and local bonds.

4. *Policyholders' Reserve Taxation*

This method is employed by the State of Massachusetts and affects most particularly legal reserve life insurance companies. These companies hold a greater proportionate share of their total assets in the form of reserves against their policy liabilities than do other types of insurance companies. The reserve tax is levied on the theory of a general property tax, recognizing that the companies' reserves are the property of the policyholders collectively and that taxation of this property is proper in a system of taxation which relies chiefly on property as a source of revenue. The rate in Massachusetts is one-fourth of 1% on the reserves held for policies issued on the lives of residents of the State. This tax is the same for both foreign and domestic companies, except that the State's retaliatory statute may invoke a higher tax when the statutes of the foreign company's state will impose such higher tax on a Massachusetts insurance company. Substantially, the Massachusetts tax is so construed as to supplant other taxes except for those imposed on real estate by local governments and the taxes on the furniture and fixtures of foreign companies located within the State. It may be stated that this tax falls more directly upon the policyholder, there being no distinction in its effect between stock and mutual insurance companies.

5. *Net Income Taxation*

The Federal Government taxes insurance companies other than life by this method, levying a percentage of tax on the companies' income after allowance for various deductions.

6. *Numerous Local Taxes of a Fee Nature Obtain*

State and municipal taxes on brokers and agents are examples.

7. *Book Value Taxation*

Although this method (in strict form) is not used, the book value of an insurance company has been discussed by some as a basis for taxa-

tion, considering it as the excess of assets over liabilities represented in the balance sheet by items of capital, surplus, undivided profits and possibly special reserve funds, etc. However, fluctuations in the market make this impractical.

Of course, reference must be made to the various statutes for full delineations.

V

State Revenues from Insurance Concerns—All Classes

The Report of the Bureau of Census, U.S. Department of Commerce, reflects that for 1942 the general revenue of the various states from taxation of insurance companies aggregated $113,022,000. A comparison from statistics in this Report shows that during that year the greatest general revenue received from insurance companies was in the State of New York where the total was $16,428,000. The lowest was in the State of Nevada with a total of $81,000. In the State of Connecticut general revenue from insurance companies amounted to $4,169,000 and in the State of Missouri to $3,250,000, the last mentioned being from premium taxes of all kinds.

Taking two other sources of revenue (public utilities and general property tax), a comparison as to the four states above mentioned reflects the following for the year 1942:

	Public utilities	Insurance companies	General property
New York	$23,537,000	$16,428,000	$2,224,000
Nevada	000	18,000	1,388,000
Connecticut	3,359,000	4,169,000	1,654,000
Missouri	15,000	3,250,000	4,721,000

The 1940 population of the State of Connecticut was 1,709,242 and from the Department of Commerce Report covering 1943, we find that its general revenue from insurance companies was $4,416,000. A comparison of this general revenue with *some* of the other sources of revenue of the State of Connecticut for that year reflects the following:

Corporations in General	$ 166,000
Alcoholic Beverages	2,026,000
Corporation Income Taxes	12,552,000
Property Taxes	2,229,000
Death and Gift Taxes	4,389,000
Sales and Gross Receipts (includes insurance taxes)	27,074,000
Motor Vehicles	7,087,000

The 1940 population of the State of Missouri was 3,784,664 and from the 1942 series on State Finances published by the U.S. Department of Commerce we find that its general revenue for the preceding biennium was $136,693,000, of which $106,005,000 was received from taxes. During this period the State of Missouri collected approximately $3,000,000 per year, or a total approximately of $60,000,000 in taxes levied on insurance companies doing business in the State. A comparison with *some* of the other sources of revenue of the State of Missouri for the biennium covered by the Department of Commerce reflects the following:

General Sales Tax	$29,514,000
Motor Fuels	14,277,000
Alcohol	5,158,000
Soft Drinks	151,000
Miscellaneous	3,000
Public Utilities	15,000
General Property Tax	4,721,000
Inheritance and Gift	1,522,000
Unemployment	23,335,000

The above rather representative comparisons indicate the place of taxation on insurance companies in relation to the general revenue of the states. It is to be kept in mind that insurance companies have never been taxed by the respective states with the primary or sole object of raising revenue, and the distinguishing aspects of the insurance business have been given great consideration by legislators in making this business a subject of taxation.

* * * *

Conclusion

There has been no attempt herein to present the subject matter in any controversial aspect, the primary object of this paper being to set forth some of the more pertinent aspects of taxation of the business of insurance by representative state governments. The tremendous extent and public import of the insurance business, as well as the distinguishing aspects of its assets, income, reserves, etc., give the subject of insurance taxation a particular and outstanding place in the state economy. Due to the impact of insurance on the lives of the citizens of the various states, it is obvious that this subject of taxation will always be given studied and serious consideration by the legislatures or other taxing bodies.

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JUSTICE LOUIS D. BRANDEIS

Excerpts from the Dissenting Opinion in Liggett v. *Lee*

A CONSIDERABLE number of American states impose special taxes on chain stores. From the small revenue produced by these taxes, the presumption is fairly drawn that they are imposed mainly to equalize competition. They have been condemned by most critics on the ground of impeding progress toward more efficient distribution. Space does not permit a selection from the ample literature presenting this point of view. The following selection * presents the unorthodox view and is an excellent statement of the antimonopoly approach to economic prob-

* 288 U.S. 517. [Footnotes omitted.]

lems. It includes selected paragraphs from a dissenting opinion in the Florida chain store tax case. The case involved a discriminatory levy on chains crossing county lines as contrasted with so-called "local" chains.

Second. The prevalence of the corporation in America has led men of this generation to act, at times, as if the privilege of doing business in corporate form were inherent in the citizen; and has led them to accept the evils attendant upon the free and unrestricted use of the corporate mechanism as if these evils were the inescapable price of civilized life and, hence, to be borne with resignation. Throughout the greater part of our history a different view prevailed. Although the value of this instrumentality in commerce and industry was fully recognized, incorporation for business was commonly denied long after it had been freely granted for religious, educational and charitable purposes. It was denied because of fear. Fear of encroachment upon the liberties and opportunities of the individual. Fear of the subjection of labor to capital. Fear of monopoly. Fear that the absorption of capital by corporations, and their perpetual life, might bring evils similar to those which attended mortmain.

There was a sense of some insidious menace inherent in large aggregations of capital, particularly when held by corporations. So, at first, the corporate privilege was granted sparingly; and only when the grant seemed necessary in order to procure for the community some specific benefit otherwise unattainable. The later enactment of general incorporation laws does not signify that the apprehension of corporate domination had been overcome. The desire for business expansion created an irresistible demand for more charters; and it was believed that under general laws embodying safeguards of universal application the scandals and favoritism incident to special incorporation could be avoided. The general laws, which long embodied severe restrictions upon size and upon the scope of corporate activity, were, in part, an expression of the desire for equality of opportunity.

* * * *

Third. Able, discerning scholars have pictured for us the economic and social results of thus removing all limitations upon the size and activities of business corporations and of vesting in their managers vast powers once exercised by stockholders—results not designed by the States and long unsuspected. They show that size alone gives to giant corporations a social significance not attached ordinarily to smaller units of private enterprise. Through size, corporations, once merely an efficient tool employed by individuals in the conduct of private business, have become an institution—an institution which has brought such concentration of economic power that so-called private corporations are sometimes able to dominate the State. The typical business corporation of the last century, owned by a small group of individuals, managed by their owners, and limited in size by their personal wealth, is being supplanted by huge concerns in which the lives of tens or hundreds of thousands of employees and the property of tens or hundreds of thousands of investors are subjected, through the corporate

mechanism, to the control of a few men. Ownership has been separated from control; and this separation has removed many of the checks which formerly operated to curb the misuse of wealth and power. And as ownership of the shares is becoming continually more dispersed, the power which formerly accompanied ownership is becoming increasingly concentrated in the hands of a few. The changes thereby wrought in the lives of the workers, of the owners and of the general public, are so fundamental and far-reaching as to lead these scholars to compare the evolving "corporate system" with the feudal system; and to lead other men of insight and experience to assert that this "master institution of civilised life" is committing it to the rule of a plutocracy.

The data submitted in support of these conclusions indicate that in the United States the process of absorption has already advanced so far that perhaps two-thirds of our industrial wealth has passed from individual possession to the ownership of large corporations whose shares are dealt in on the stock exchange; that 200 non-banking corporations, each with assets in excess of $90,000,000, control directly about one-fourth of all our national wealth, and that their influence extends far beyond the assets under their direct control; that these 200 corporations, while nominally controlled by about 2,000 directors, are actually dominated by a few hundred persons—the negation of industrial democracy. Other writers have shown that, coincident with the growth of these giant corporations, there has occurred a marked concentration of individual wealth; and that the resulting disparity in incomes is a major cause of the existing depression. Such is the Frankenstein monster which States have created by their corporation laws.

Fourth. Among these 200 corporations, each with assets in excess of $90,000,000, are five of the plaintiffs. These five have in the aggregate, $820,000,000 of assets; and they operate, in the several States, an aggregate of 19,718 stores. A single one of these giants operates nearly 16,000. Against these plaintiffs, and other owners of multiple stores, the individual retailers of Florida are engaged in a struggle to preserve their independence—perhaps a struggle for existence. The citizens of the State, considering themselves vitally interested in this seemingly unequal struggle, have undertaken to aid the individual retailers by subjecting the owners of multiple stores to the handicap of higher license fees. They may have done so merely in order to preserve competition. But their purpose may have been a broader and deeper one. They may have believed that the chain store, by furthering the concentration of wealth and of power and by promoting absentee ownership, is thwarting American ideals; that it is making impossible equality of opportunity; that it is converting independent tradesmen into clerks; and that it is sapping the resources, the vigor and the hope of the smaller cities and towns.

The plaintiffs insist that no taxable difference exists between the owner of multiple stores and the owner of an individual store. A short answer to the contention has already been given, so far as required for the decision of this case. It is that the license fee is not merely taxation. The fee is the compensation exacted for the privilege of carrying on intrastate business in corporate form. As

this privilege is one which a State may withhold or grant, it may charge such compensation as it pleases. Nothing in the Federal Constitution requires that the compensation demanded for the privilege should be reasonable. Moreover, since the authority to operate many stores, or to operate in two or more counties, is certainly a broader privilege than to operate only one store, or in only one county, there is in this record no basis for a finding that it is unreasonable to make the charge higher for the greater privilege.

A more comprehensive answer should, however, be given. The purpose of the Florida statute is not, like ordinary taxation, merely to raise revenue. Its main purpose is social and economic. The chain store is treated as a thing menacing the public welfare. The aim of the statute, at the lowest, is to preserve the competition of the independent stores with the chain stores; at the highest, its aim is to eliminate altogether the corporate chain stores from retail distribution. The legislation reminds of that by which Florida and other States, in order to eliminate the "premium system" in merchandising, exacted high license fees of merchants who offered trading stamps with their goods. *Rast* v. *Van Deman & Lewis Co.*, 240 U.S. 342; *Tanner* v. *Little*, 240 U.S. 369. Compare *Central Lumber Co.* v. *South Dakota*, 226 U.S. 157; *Singer Sewing Machine Co.* v. *Brickell*, 233 U.S. 304.

The plaintiffs discuss the broad question whether the power to tax may be used for the purpose of curbing, or of exterminating, the chain stores by whomsoever owned. It is settled that a State "may carry out a policy" by "adjusting its revenue laws and taxing system in such a way as to favor certain industries or forms of industry." *Quong Wing* v. *Kirkendall*, 223 U.S. 59, 62; *Citizens Telephone Co.* v. *Fuller*, 229 U.S. 322, 329. And since the Fourteenth Amendment "was not intended to compel the State to adopt an iron rule of equal taxation," *Bell's Gap R. Co.* v. *Pennsylvania*, 134 U.S. 232, 237, it may exempt from taxation kinds of business which it wishes to promote; *American Sugar Refining Co.* v. *Louisiana*, 179 U.S. 89; *Southwestern Oil Co.* v. *Texas*, 217 U.S. 114; and may burden more heavily kinds of business which it wishes to discourage. *Williams* v. *Fears*, 179 U.S. 271; *Armour Packing Co.* v. *Lacy*, 200 U.S. 226; *Brown-Forman Co.* v. *Kentucky*, 217 U.S. 563; compare *Alaska Fish Co.* v. *Smith*, 255 U.S. 44. To do that has been the practice also of the Federal Government. It protects, by customs duties, our manufacturers and producers from the competition of foreigners. Compare *Hampton & Co.* v. *United States*, 276 U.S. 394, 411–413; also, *Billings* v. *United States*, 232 U.S. 261. It protects, by the oleomargarine laws, our farmers and dairymen from the competition of other Americans. Compare *McCray* v. *United States*, 195 U.S. 27. It eliminated, by a prohibitive tax, the issue of state bank notes in competition with those of national banks. Compare *Veazie Bank* v. *Fenno*, 8 Wall. 533. Such is the constitutional power of Congress and of the state legislatures. The wisdom of its exercise is not the concern of this Court.

Whether chain stores owned by individuals may be subjected to the discrimination here challenged need not, however, be decided. This case requires decision only of the nar-

rower question—whether the State may freely apply discrimination in license fees against corporate chain stores. The essential difference between corporations and natural persons has been recognized by the Federal Government in taxing the income of businesses when conducted by corporations, while exempting a similar business when carried on by an individual or partnership. *Flint* v. *Stone-Tracy Co.,* 220 U.S. 107, 158. It has, at other times, imposed upon businesses conducted by corporations heavier taxes than upon those conducted by individuals. The equality clause of the Fourteenth Amendment presents no obstacle to a State, likewise, taxing businesses engaged in intrastate commerce differently according to the instruments by which they are carried on; provided the purpose of the discrimination is a permissible one, the discrimination employed a means appropriate to achieving the end sought, and the difference in the instruments so employed vital. Compare *Fort Smith Lumber Co.* v. *Arkansas,* 251 U.S. 532. *Quong Wing* v. *Kirkendall,* 223 U.S. 59; *Amoskeag Savings Bank* v. *Purdy,* 231 U.S. 373; *Singer Sewing Machine Co.* v. *Brickell,* 233 U.S. 304. The corporate mechanism is obviously a vital element in the conduct of business. The encouragement or discouragement of competition is an end for which the power of taxation may be exerted. And discrimination in the rate of taxation is an effective means to that end.

The requirement of the equality clause that classification "must rest upon some ground of difference having a fair and substantial relation to the object of the legislation," *Louisville Gas & Electric Co.* v. *Coleman,* 277 U.S. 32, 37, is here satisfied. Mere difference in degree has been widely applied as a difference justifying different taxation or regulation. The difference in power between corporations and natural persons is ample basis for placing them in different classes. Even as between natural persons, where the equality clause applies rigidly, differences in size furnish an adequate basis for discrimination in a tax rate. The size of estates, or of bequests, is the difference on which rest all the progressive inheritance taxes of the States and of the Nation. *Magoun* v. *Illinois Trust & Savings Bank,* 170 U.S. 283, 293; *Knowlton* v. *Moore,* 178 U.S. 41, 109; *Keeney* v. *New York,* 222 U.S. 525, 536; *Maxwell* v. *Bugbee,* 250 U.S. 525; *Salomon* v. *State Tax Commission,* 278 U.S. 484. Differences in the size of incomes is the basis on which rest all progressive income taxes. *Brushaber* v. *Union Pacific R. Co.,* 240 U.S. 1, 25. Differences in the size of businesses present, likewise, an adequate basis for different rates of taxation. Compare *Citizens Telephone Co.* v. *Fuller,* 229 U.S. 322, 331; *Pacific American Fisheries Co.* v. *Alaska,* 269 U.S. 269. And so do differences in the extent or field of operation.

The State might justify progressively higher license fees for corporations of larger size, or a more extended field of operation, on the oft-asserted ground that such concerns are more efficient than smaller units and, hence, that they can, and should, contribute more to the public revenues. But the State need not rest the difference in tax rates on a ground so debatable as the assertion that efficiency increases with size. The Federal Constitution does not require that taxes (as distinguished from assessments for betterments) be

proportionate to the differences in benefits received by the taxpayers, compare *Illinois Central R. Co.* v. *Decatur,* 147 U.S. 190, 197; *Union Transit Co.* v. *Kentucky,* 199 U.S. 194, 203; *Southern Pacific Co.* v. *Kentucky,* 222 U.S. 63, 76; *St. Louis & Southwestern Ry.* v. *Nattin,* 277 U.S. 157, 159; or that taxes be proportionate to the taxpayer's ability to bear the burden.

Since business must yield to the paramount interests of the community in times of peace as well as in times of war, a State may prohibit a business found to be noxious and, likewise, may prohibit incidents or excrescences of a business otherwise beneficent. *Mugler* v. *Kansas,* 123 U.S. 623; *Ozan Lumber Co.* v. *Union County Bank,* 207 U.S. 251; *Williams* v. *Arkansas,* 217 U.S. 79; *Engel* v. *O'Malley,* 219 U.S. 128; *Central Lumber Co.* v. *South Dakota,* 226 U.S. 157. Businesses may become as harmful to the community by excessive size, as by monopoly or the commonly recognized restraints of trade. If the State should conclude that bigness in retail merchandising as manifested in corporate chain stores menaces the public welfare, it might prohibit the excessive size or extent of that business as it prohibits excessive size or weight in motor trucks or excessive height in the buildings of a city. Compare *Morris* v. *Duby,* 274 U.S. 135; *Welch* v. *Swasey,* 214 U.S. 91; *Euclid* v. *Ambler Realty Co.,* 272 U.S. 365, 388. It was said in *United States* v. *U.S. Steel Corp.,* 251 U.S. 417, 451, that the Sherman Anti-Trust Act did not forbid large aggregations; but the power of Congress to prohibit corporations of a size deemed excessive from engaging in interstate commerce was not questioned.

The elimination of chain stores, deemed harmful or menacing because of their bigness, may be achieved by levelling the prohibition against the corporate mechanism—the instrument by means of which excessive size is commonly made possible. Or, instead of absolutely prohibiting the corporate chain store, the State might conclude that it should first try the more temperate remedy of curbing the chain by imposing the handicap of discriminatory license fees. Compare *St. Louis Poster Advertising Co.* v. *St. Louis,* 249 U.S. 269, 274; *Hammond Packing Co.* v. *Montana,* 233 U.S. 331, 333–334; *Bradley* v. *Richmond,* 227 U.S. 477, 480. "Taxation is regulation just as prohibition is." *Compania General de Tabacos* v. *Collector,* 275 U.S. 87, 96. And the State's power to make social and economic experiments is a broad one.

* * * *

Sixth. The plaintiffs contend, for a further reason, that there is no taxable difference justifying the discrimination in license fees. They assert that the struggle between them and the independently owned stores is, in fact, not an unequal one; and in support of this assertion, they call attention to those paragraphs in the bill which describe the cooperative chains of individual stores and their rapid growth. These paragraphs allege that by "affiliations and cooperative organizations single grocery [and other] store owners have adopted the best features of chain store merchandising and have secured substantially all the benefits derived therefrom, while at the same time they have avoided burdens of capital investment, insurance, etc., incident to the carrying of a large stock in a central warehouse." The bill sets forth how

this has been achieved, describing in detail the recent advances in efficiency of such cooperative merchandising. It alleges, moreover, that the members of a cooperative chain have the superior advantage of the good will and personal interest of the individual owners, as compared with the hired managers of the regular chains; and that all these facts were known to the Legislature when it enacted the statute here challenged.

These allegations are admitted by the motion to dismiss; and they are supported by recent experience of which we may take notice. But it does not follow that because the independently owned stores are overcoming through cooperation the advantages once possessed by chain stores, there is no taxable difference between the corporate chain and the single store. The State's power to apply discriminatory taxation as a means of preventing domination of intrastate commerce by capitalistic corporations is not conditioned upon the existence of economic need. It flows from the broader right of Americans to preserve, and to establish from time to time, such institutions, social and economic, as seem to them desirable; and, likewise, to end those which they deem undesirable. The State might, if conditions warranted, subject giant corporations to a control similar to that now exerted over public utility companies. Or, the citizens of Florida might conceivably escape from the domination of giant corporations by having the State engage in business. Compare *Jones* v. *Portland*, 245 U.S. 217; *Green* v. *Frazier*, 253 U.S. 233; *Standard Oil Co.* v. *Lincoln*, 275 U.S. 504. But Americans seeking escape from corporate domination have open to them under the Constitution another form of social and economic control—one more in keeping with our traditions and aspirations. They may prefer the way of cooperation, which leads directly to the freedom and the equality of opportunity which the Fourteenth Amendment aims to secure. That way is clearly open. For the fundamental difference between capitalistic enterprise and the cooperative—between economic absolutism and industrial democracy—is one which has been commonly accepted by legislatures and the courts as justifying discrimination in both regulation and taxation. *Liberty Warehouse Co.* v. *Burley Tobacco Growers Assn.*, 276 U.S. 71. Compare *Citizens Telephone Co.* v. *Fuller*, 229 U.S. 322.

There is a widespread belief that the existing unemployment is the result, in large part, of the gross inequality in the distribution of wealth and income which giant corporations have fostered; that by the control which the few have exerted through giant corporations, individual initiative and effort are being paralyzed, creative power impaired and human happiness lessened; that the true prosperity of our past came not from big business, but through the courage, the energy and the resourcefulness of small men; that only by releasing from corporate control the faculties of the unknown many, only by reopening to them the opportunities for leadership, can confidence in our future be restored and the existing misery be overcome; and that only through participation by the many in the responsibilities and determinations of business, can Americans secure the moral and intellectual development which is essential to the maintenance of liberty.

If the citizens of Florida share that belief, I know of nothing in the Federal Constitution which precludes the State from endeavoring to give it effect and prevent domination in intrastate commerce by subjecting corporate chains to discriminatory license fees. To that extent, the citizens of each State are still masters of their destiny.

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CHAPTER 7

CONSUMPTION TAXES

TAXES on exchange transactions are one of the oldest and also one of the most firmly established means of filling the public treasury. Consumers are not ordinarily taxed directly, but they are obliged to shoulder a large part of the tax load indirectly. The tax system reaches them through the prices of goods and services. The propriety of this indirect taxation has been the subject of prolonged debate. It is argued that these taxes are irrational and regressive, falling with least relative weight on those most able to pay. But it is answered that indirect taxes have solid, practical virtues; they yield well and are convenient to pay and easy to collect. Moreover, they are said to afford a first-rate weapon for coping with inflation.

Consumption taxes, like business taxes, may be general or special. The former are frequently designated "sales taxes" and the latter "excises." The two major excises in the United States are those on liquor and tobacco. Both afford unique problems, among which is the question of whether they should be used exclusively by the federal government, or by state governments, or by both. Sharing may take the form of overlapping taxes or of division of the revenue from these sources.

General sales taxes are not so simple as some proponents suggest. Problems of definition are encountered: should these taxes be confined to goods destined for consumers or should they also include producers' equipment goods? In the case of retail sales, how can a two-percent tax be applied to a five-cent purchase? When is a state tax a "tariff" on interstate commerce, prohibited by our federal constitution?

Sales taxes applied exclusively to international trade are called tariffs, and these are universally an important source of national revenue. In the early history of the United States they constituted virtually the whole federal tax system. No element in the revenue system has been subject to more debate. In addition to tax problems, the tariff injects into public finance the politics and economics of protecting domestic industries from foreign competition. This has been a favorite topic of economists since their earliest tracts appeared.

E.R.A. SELIGMAN

The Arguments For and Against the Sales Tax

THE first two selections of this chapter are devoted to the arguments for and against the general sales tax. Because of its earlier appearance, the negative argument of Professor Seligman is presented first.*

The conclusion to be drawn from this historical survey is that the general sales tax constitutes the last resort of countries which find themselves in such fiscal difficulties that they must subordinate all other principles of taxation to that of adequacy.

There are four principles of taxation which the statesman must observe in framing a fiscal system. First is the principle of adequacy. If a tax does not yield the desired revenue it is a failure. The paramount consideration in almost every tax is that it should raise money. Second, there is the principle of what might be called innocuity, i.e., of doing as little harm as possible to the community. Violation of that principle was the trouble with our excess-profits tax. Its unlooked-for practical results were such that despite certain theoretical advantages it really reduced the national dividend instead of increasing it.

Third, there are the administrative principles laid down by Adam Smith. The tax must not be too complicated; it must be certain; it must be convenient. If the tax does not work administratively, no matter how ideal it is otherwise, it is a poor tax. Finally, we come to the principle of equality. All these other considerations being observed, the object of a statesman must be to frame a system of taxation which will be as nearly equal as possible, not only between the individual taxpayers, but between the various classes in the community.

The sales tax, it is evident, sins against every one of these principles. First as to adequacy. If the tax were adopted, it is exceedingly probable that the mediæval lesson, as well as the more recent experience of France would be repeated; and that the revenue would be woefully inadequate. There are no means of estimating, with any degree of precision, what such a tax will actually yield. Some of our so-called "experts" tell us that a one per cent tax will yield six billion dollars; others put the yield as low as half a billion dollars. Where such enormous disparities exist in the estimates, it behooves us to be exceedingly conservative in our expectations. It is not probable that the actual yield of the

* From Edwin R. A. Seligman, *Studies in Public Finance* (1925), pp. 131–138. By permission of The Macmillan Company, publishers.

tax will suffice to realize the cherished plans of its advocates, in replacing some of the existing revenues.

We come next to the question as to the probable effect of the tax upon the community. Several points are to be mentioned here. A controversy has arisen as to who will pay the tax. If the tax is imposed on the commodities in the hands of the purchaser, there is no doubt as to the fact that the consumer will pay, even though the restriction of his purchases may also exert a prejudicial effect on the turnover of the seller. The question is as to what will happen in case the tax is imposed on the seller, rather than the purchaser. The consequences will be almost equally injurious irrespective of the reply to be given to this question. If the tax is shifted to the purchaser, its effect will be doubly baleful. For in the first case, as we shall see in a moment, it will amount to a tax on expenditure and thus invert the principle of ability to pay. In the second place, the tax will be cumulative or to use a common term, pyramided, so that the price of the commodity will in the end be raised by much more than the original rate of the tax. This constitutes the familiar difference between a tax on output, and a tax on turnover or sales. In the former case, the tax being levied at the initial stage of the process, the price will be increased on every subsequent transaction, if at all, only by the interest on the capital involved; while in the latter case, inasmuch as the price will in each case be increased by the profits of the antecedent transaction, the tax will be paid on this continually augmented level of price. As a result, a general sales tax of one per cent may in the end constitute far more than one per cent of the original selling price. The tax in other words will be pyramided; it will be cumulative in character.

On the other hand, if the tax is not shifted to the consumer, it is also open to two criticisms. For if the tax remains on the producer, it will be equivalent to a tax on gross receipts. A tax on gross receipts is like the tithe: gross receipts are no indication of the real profitableness of the business. Taxes on output or gross receipts which make no allowance for the expenses constitute a rough and ready system, suitable only for the more primitive stages of economic life. In modern times, just as the tithe has been replaced by the tax on net produce or on the capitalized net produce in the shape of selling value, so the tax on gross receipts is everywhere giving way to the tax on profits or net receipts. Under our present business practice a tax on gross receipts would be exceedingly inequitable as between various classes of business, or as between different individuals in the same class, depending largely on the rapidity of the turnover. Figures that have been compiled tend to show that a tax of one per cent on gross sales would amount in some cases to five per cent of the net income and in other cases to as much as thirty per cent. In a business community which is striving more and more to adjust its taxation to the ability of the individual such a reversion to bygone practices would seem to be unwise in the extreme.

In another respect also the sales tax, if it rests on the seller, would be inequitable. It would affect business very differently according as we were dealing with so-called multiple-proc-

ess organizations or with simple and less integrated enterprises. There is a great difference between so-called single-process business, *i.e.*, those which concentrate on one process, and the larger enterprises which carry on several processes at once. We have not a few textile plants which buy the cotton from the ginning mill, and sell the finished product through their own selling organization to the wholesaler, and even in some cases to the retailer. In the same way the United States Steel Corporation owns mines, railroads and steamboats, as well as open-hearth plants and may in the case of tools supply its products direct to the mail order house. We find in modern times not only vertical but horizontal integration in business plants and enterprises. A general sales tax will obviously afford decided advantages to the organization which is able to dispense with the various stages in the purchase of the products needed in the successive processes. This consideration is a familiar one in fiscal literature, having been emphasized half a century ago by Leroy-Beaulieu. He tells us that:

> In order to establish the turnover tax, we do not say with complete justice but without a monstrous and revolting inequality, it would be necessary to make a classification of industries and professions, and to fix a different rate for each. This would land us in well-nigh inextricable difficulties. . . .
>
> Another defect of this tax is that it would be shifted very unequally in the case of identical products. The subdivided industries where the same commodity, before reaching the final stage of readiness for sale, passes through several hands, would have to endure a burden infinitely more heavy than similar industries where all the operations are concentrated in one plant. In this way a kind of privilege would be accorded to the large, as over against the small enterprise.*

The adoption of a general sales tax would moreover tend to bring about great changes in business practice, looking toward the elimination of the middleman, even where he had shown his superior economic efficiency. In the attempt to economize in the tax, the best interests of the consumer might be sacrificed.

We come in the third place to a consideration of the administrative objections to the general sales tax. It is questionable whether these have been adequately realized. The administration of ordinary taxes on property or profits is difficult enough, even if we have to deal only with those individuals or businesses that possess the given minimum of property or profits. But in the case of a general sales tax we are dealing with the totality of the community, with every individual—man, woman or child—who buys any commodity that is offered for sale. We are dealing with the small man as well as the big man—with the patron of a five or ten cent store as well as the purchaser of a Rolls-Royce or a palatial yacht. What possible devices can be utilized to guard against wholesale fraud and evasion, when it is to the interest of both buyer and seller to avoid the tax. Especially in a democracy like ours, where the administrative system is proverbially weak, the attempt to levy a general sales tax would impose upon our officials an administrative burden for which they are hopelessly unprepared. The defects of our so-called "nuisance taxes" are fairly widely recognized; but they are insignificant when com-

* Original French version omitted. [Editor's note.]

pared to the probable results of a general sales tax with all its complexities and its uncertainties.

Finally if the general sales tax is defective from the point of view of adequacy, of consequences on business prosperity and of good administration, it is above all to be criticized from the point of view of fiscal justice. This brings us to the chief criticism to be urged against a general tales tax: it is a tax on consumption, on expenditure. We do not object to all taxes on consumption; for every well-balanced system of taxation should include indirect as well as direct taxes. But there is consumption and consumption. There are articles of luxurious consumption; there are articles of convenient consumption; there are articles of necessary consumption. The sales taxes that we have in this country today and which are found in other Anglo-Saxon countries as well, are with few exceptions taxes on the sale (and sometimes the production) of articles of luxurious consumption or of the widespread consumption of what cannot really be called necessaries, as for example, tobacco and liquor before the present dispensation. But when we come to a general sales tax, we are dealing primarily with a tax on necessaries, inasmuch as the great mass of commodities consists of articles used by the people in modest circumstances. Therefore, as the French writers in the Middle Ages pointed out, a general sales tax is a sort of inverted income tax. Instead of taxing the man with a higher income more, as we do, you tax the man with the higher income less—not indeed actually less, but relatively less in proportion to his wealth as measured by property or by income. For although the rich man consumes more than the poor man, and will accordingly pay a larger tax, the amount of his consumption or of his purchases will not increase in proportion to his wealth. Above all a general sales tax would render impossible the application of a graduated or progressive scale of taxation. It would in fact amount to an upside-down system of progressive taxation. It is this instinctive reaction of the common man to the proposal of a sales tax which is responsible for the opposition manifested from the time of the Romans through the Middle Ages, down to modern times. At this very moment in this country, the laboring classes and farmers are up in arms against it. And they are right.

It may be true that our present revenue system errs on the side of taxing wealth unduly and consumption not enough. But if we were to abolish the excess-profits tax, reduce the surtaxes on incomes and then substitute a general sales tax, the shoe would pinch on the other foot. Instead of deriving most of our revenues from wealth, as we do at present, we should have more than half of the entire revenue coming not only from taxes on consumption, but from taxes on the necessaries of life. That is a situation which can not be contemplated with equanimity.

In their legitimate and comprehensible enthusiasm to reduce the present crushing burden of taxes on income and profits, some of our business men have resuscitated the project of a general sales tax, and some of our political leaders have lent too ready an ear to their demands. These business men and these political leaders are sadly mistaken. They have failed to analyze

the true bearings of the system which they recommend; they have omitted to study the consequences upon business life itself; they have been blind to the essential injustice of the project. The general sales tax is a discredited remnant of an outworn system; it is essentially undemocratic in its nature; and it would, if enacted, exaggerate rather than attenuate, the present inequalities of wealth and opportunity.[1]

[1] The Senate Finance Committee to which this memorandum was submitted, finally decided, notwithstanding the views of Senator Smoot, against the adoption of the tax. In the House it never had much chance of success.

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HARLEY L. LUTZ

In Favor of the Sales Tax *

The confusion over the revenue situation is exceeded only by the chaos on the labor front. In both cases the collapse of leadership is the product of a prolonged unwillingness to face some very real, but unpleasant facts. In both cases vigorous action is called for if further deterioration is to be avoided.

The concern here is with the fiscal problem. The Treasury proposed new revenues of $10.5 billion, and the Ways and Means Committee is reported to be designing a bill to produce about $2 billion.[1] The Treasury program was rejected because it involved severe increases on persons and corporations already taxed near the limit. But the committee's substitute is likely to be quite as objectionable since it is reported to involve heavier excise taxes on many commodities that likewise are already taxed near the limit.

The feature of the Treasury proposal that provided the chief political ammunition against the whole scheme was the suggestion to repeal the Victory Tax. It was alleged that this would relieve some 9,000,000 persons from income tax. While there are sound economic and fiscal reasons, as well as cogent political reasons, against relieving any one from a share in the war taxes, a unique opportunity was lost in not taking advantage of the proposed Victory Tax repeal to introduce a simpler, more efficient method of taxing the small incomes. This method is the retail sales tax.

[1] Written in November, 1943. The reference is to the controversy over the Revenue Bill of 1943.

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In Chap. XI it was pointed out that

1. Consolidation and simplification of the income tax are imperative.

2. The income tax is not the best method of taxing the small incomes.

3. The sales tax and the income tax can be used in conjunction with a substantial gain in net revenues.

The failure to consider the sales tax more seriously is probably to be attributed to the skillful use of certain arguments against it without adequate consideration of the degree to which these contentions can be answered or offset. Despite the present dark prospect for action, a review of the objections is worth while. The weight of any objection is greatly diminished by the urgency of the war revenue need and by the great burden of the other taxes already developed. In any period of serious revenue strain, like the present, it is far better to spread the load through diverse taxes than to concentrate it too heavily at a few points.

The Treasury Department has recently issued, in mimeograph form, a series of studies of the sales tax,[2] covering some of its theoretical aspects and a summary of the laws here and elsewhere. The principal theoretical discussion was devoted to the relation of the sales tax to the inflation control program. The customary stock objection, *viz.*, regressivity, was mentioned frequently, but there was no separate development of this theme. A realistic view of the entire tax structure would compel any one to arrive at the conclusion that is set out in the study in the following:[3] "The problem of regressiveness itself may not be too serious during a period when income tax rates are being made more progressive, but the problem of the tax burden on the very low income persons remains."

This aspect of the subject will be discussed later. The first matter to be dealt with is the treatment of the sales tax in relation to the inflation program.

The procedure that was employed in shaping the argument is an excellent example of what happens when the newfangled theories of fiscal policy are applied. According to these theories, finance is to be regarded as an "instrument of policy." This means that taxation, public credit, and public spending are to be used as devices to manipulate the economy, to produce inflation or deflation, and, in general, to secure those results which some person, or agency, or clique, deems desirable. Under this philosophy, revenue, per se, is not important, for such funds as may be required can always be obtained through loans.

In the present instance, the paramount issue is said to be the matter of inflation control, and the decision for or against a particular tax is apparently to be made, not in the light of its revenue possibilities but in the light of an official pronouncement that it will affect, in one way or another, some other aspect of policy. The following passage illustrates this conception:[4] "It is one of the prin-

[2] *Considerations Respecting a Federal Retail Sales Tax,* in three parts, (Division of Tax Research, Treasury Department, Oct. 12, 1943).

[3] *Ibid.,* Part A, Section entitled "Factors Affecting the Structure of a Federal Retail Sales Tax under Wartime Conditions," p. 24.

[4] *Ibid.,* Part B, Section entitled "Effects of a Federal Retail Sales Tax on the Anti-inflation Program," p. 1. Unless otherwise indicated, all subsequent quotations are from this section of the study.

cipal functions of wartime tax policy to buttress the anti-inflation program by preventing excess consumer spending power from being used to bid up, or inflate, selling prices."

Taken literally, this statement appears to make a good case for a sales tax, since it tends to absorb purchasing power and thus to restrict the bidding up of prices. While this effect is conceded in the study, the concession is qualified by suggesting that the tax would curtail saving rather than spending, although it is pointed out that this result would be more likely in the higher income groups. The redistribution of spending thus suggested does not take account of the current, or possible future point rationing and the limitations on spending, regardless of income, thereby imposed. The entire discussion overlooks the influence of the rationing system, which reduces spending for all rationed goods so drastically. It would be illuminating to know what proportion of the population consistently runs out of money before it runs out of points. By and large, it is the other way around.

For some singular reason, possibly connected with the "finance as policy" doctrine, the Treasury has been unwilling to accept the logic of its own data. Thus, the study concedes that the sales tax will curb the tendency to bid up prices on the part of the lower income groups. And another Treasury compilation shows conclusively that the vast bulk of the spending power is in the incomes under \$5,000. Table VIII is taken from that compilation.

The progressivity of the existing tax system, in relation to incomes, is shown by the bottom line of the table, which was not in the original

TABLE VIII

ESTIMATED DISTRIBUTION, BY NET INCOME CLASSES, OF INCOME RECIPIENTS, INCOME PAYMENTS, AND PERSONAL TAXES, AT LEVELS OF INCOME ESTIMATED FOR THE CALENDAR YEAR 1944

(Number of Recipients in Millions; Dollar Amounts in Billions)

	Total	Distribution by Net Income Classes			
		0–\$1,000	\$1,000–3,000	\$3,000–5,000	\$5,000 and over
Number of income recipients	67.3	21.6	36.6	6.7	2.4
Total income payments [1]	\$157.0	\$19.2	\$77.1	\$30.7	\$30.0
Less personal taxes [2]	\$ 20.1	\$ 0.5	\$ 6.6	\$ 4.0	\$ 9.0
Total income payments after personal taxes	\$136.9	\$18.7	\$70.5	\$26.7	\$21.0
Percentage of income after taxes to total income [3]	87.2	97.4	91.4	87.0	70.0

[1] Income payments are as defined by the Department of Commerce.

[2] Includes estimated Federal individual income tax liabilities under present law for the full taxable year (but excluding non-recurring liabilities under the Current Tax Payment Act of 1943 incurred in the transition to a pay-as-you-go basis), Federal estate and gift taxes, and state and local personal taxes comprising individual income taxes, estate and gift taxes, property taxes (excluding taxes on business property and rented houses) and miscellaneous personal taxes.

[3] This line has been added by the writer.

exhibit. This tendency is much more extreme, naturally, in the case of the higher incomes. In the net income classes of $25,000 and over, only 44.6 per cent of total income would be left after taxes.

According to these estimates, 80.9 per cent of all income payments in 1944 were to be in the net income classes of $5,000 or less. They leave no doubt as to where the excess consumer spending power will be chiefly located. The huge volume of that estimated income, assuming that the calculation is reasonably dependable, leaves no doubt, either, that more tax revenue can and should be obtained than now appears likely to be collected. The only question remaining unanswered is, "What is the best way to get more revenue from this area of the national income?"

For the Treasury's answer, we turn again to the study referred to, where the following specifications are given for any new tax which it would regard as satisfactory:

> To contribute to the anti-inflationary program, a tax should satisfy both of these criteria: (1) It should curtail excess consumer spending with a minimum impairment of productive efficiency and incentives. (2) It should not interfere with the Government's capacity to "hold the line" against inflation through its direct anti-inflation controls.

It should be noted again that the emphasis here is not on revenue but on inflation control. There seems to be no appreciation of the fact that as tax revenues are increased bank loans are diminished, and it is universally agreed that the chief primary source of the inflation menace is the bank loan. Consequently, under a simple and uncomplicated fiscal policy of raising the maximum revenue possible, in the most effective manner possible, it would turn out that the greatest service had been done to the anti-inflation program.

Had the matter been approached in this light, there is excellent reason for believing that a sales tax would involve a minimum of further impairment of efficiency and incentive, because of its certainty and convenience, and its element of discretionary control, however small, which the taxpayer has over the total amount. It is submitted, in repetition of what was said in the October 1943 *Tax Review*, that a different tax would be less likely to provoke irritation and disaffection than would a further increase in the income tax rates, particularly if these increases were to be made before the millions of new taxpayers had become familiar with, and in some measure accustomed to, the complications of the income tax.

There remains, then, the chief point that is emphasized in the argument against the sales tax, *viz.*, that it would interfere with the capacity to "hold the line" against inflation. This criterion, it is explained, is "peculiar to the specific price and wage controls which are being heavily relied upon by the Federal Government in its attempt to stem the rising tide of inflation." In one sense, therefore, the Treasury's case is proved by definition. That is, since the entire theory of inflation control is based on "the careful maintenance of inter-price and wage-price balance in the economy," it follows by definition that any tax which disturbs this delicate balance makes the maintenance of a balance more difficult.

Despite the admissions made to the effect that the sales tax is not inflationary, and hence would not seriously disturb the various delicate

balances which the government seeks to preserve, the conclusion is reached that a Federal retail sales tax would be inflationary. Therefore, regardless of the amount of revenue it would produce and regardless of the direct contribution thus made to the limitation of the true source of the inflationary force, the thesis is developed that a Federal retail sales tax would be the fiscal bull in the wage-price china shop. The study offers the following reasons for this conclusion:

1. That the retail sales tax means an increase of retail prices, which, by definition, is inflationary.

But the sales tax need not be so defined. It can and should be shown as an item to be paid outside the regular price, which is the same after as before the tax. More money, by the amount of the tax, comes out of the consumer's pocket. And so we have the paradoxical result that an absorption of purchasing power by the tax is anti-inflationary, but the payment of a higher "price" (including the tax) would be inflationary.

2. That the retail sales tax would enter into costs and lead to an upward revision of retail prices.

The logic used to establish this point is always conditional. If certain things are done, then certain results ensue. The principal sources of price increase, as a result of a retail sales tax, were said to be the following.

a. Prices would be increased directly *if* the tax were levied on sales of articles to final users when the use is a step in production. Sales of feed, seed, fertilizer, and machinery to farmers, sales of fuel and lubricating oil to industry, sales of cartons and bottles to dealers were cited as illustrative.

It is true that the distinction between use of a commodity as a capital good and as a final consumer good has occasioned some difficulty. But with a reasonable intent to establish a proper line of distinction between capital uses and consumption uses, the area of such difficulties should be reducible to minor, even negligible proportions.

b. *If* the tax were considered in computing the parity index, it would be necessary to readjust the prices of farm products. The statement is made that if a 10 per cent retail sales tax had been operative since July 1, 1943, the parity index would be raised in 1944 by 6 to 7 per cent, and that this, plus the tax itself, would mean a 17 per cent increase of retail food costs.

c. Likewise, *if* the tax were to be included in the cost-of-living index, the advance that would be registered by this index would constitute a case for some wage increases, and a basis for leverage all along the line.

An answer to these "ifs" is given in the final paragraph of the study. This paragraph is as follows:

> Finally, it may be that the inflationary tendencies of the sales tax would be reduced if the statute required that the tax be added to selling prices as a separately-quoted item, and if a policy statement were included in the statute to the effect that wage increases and price increases (other than the price rises reflecting the shifting of the tax forward by retailers to consumers) to compensate for the sales tax would be wholly inconsistent with wartime tax policy and anti-inflation controls. Even if these steps were taken, however, the pressures generated by the tax would still remain.

Fundamentally, the sales tax is not to be viewed as part of the cost of living but as a means of financing the war. The readjustment of the income of any group to compensate

for a tax paid by its members means relieving those persons from sharing in the war costs. Pushed to its logical conclusion, such a scheme means the end of all taxation, for the government would raise all incomes by the amount of the taxes collected.

In his message on the food subsidy, sent to Congress on Nov. 1, 1943, President Roosevelt made a complete case against any concern over the effect of the sales tax on the farmers, and, without direct reference, against any such phony statistical trick as the inclusion of the tax in computing parity index. Incidentally, he made a very good case against his proposed subsidy. The pertinent paragraphs of the message follow:

> The administration of the food program has certainly resulted in a great benefit to farmers. Farm income last year reached an all-time peak—and this year it will be higher still. The increase in the prices that farmers pay for the commodities they buy, on the other hand, has been held to very much less than the increase in the prices they receive for their farm products.

In consequence, the net income of farm operators—income after all expenses—has risen to the highest level ever enjoyed by farmers. The average annual realized net income of the farm operators of the nation during the five pre-war years, 1935 to 1939, was $4,668,000,000. The realized net income for 1939 was $4,430,000,000. In 1942 it was $9,500,000,000. The estimate for 1943 is $12,475,000,000. . . .

In plain language, the farmer this year, is not only better off in relation to others in the population than he was before the war broke out; he is better off than he was in the base period 1910 to 1914, and better off than he has been in any year since that time.

The author of the Treasury study meets his own arguments quite frankly in the following statement:

> If the Government stabilization policy could be applied firmly and administered effectively regardless of the pressures caused by the sales tax, the price and wage increases stimulated by the tax could be held to minor proportions. Only with respect to those prices and wages not subject to control by the Office of Economic Stabilization would the inflationary influences of the tax have free play. These uncontrolled areas are not important in terms of the over-all inflation picture. While the agricultural price increases generated by the tax might be important, these increases would be self-limiting, assuming that the wages and prices subject to Government control were effectively stabilized.
>
> From a realistic viewpoint, however, absolutely rigid application of price and wage controls in the face of the many pressures resulting from the sales tax cannot be expected. Some upward price-ceiling adjustments would have to be permitted by the authorities. Wage increases might also prove necessary in some cases. To the extent that a firm and effective stabilization policy was not maintained, the inflationary forces would be encouraged and permitted to cumulate. In such a situation it would be considerably more difficult to prevent serious wartime inflation.

In other words, when the smoke clears away, it turns out that the real inflationary force is not the sales tax, per se, but the inability of the government to deal firmly and effectively with the whole subject of prices and wages. Because of this inability, which goes back to the timidity, foggy thinking, and group favoritism of the policy-framing days in the early defense and war periods, it is now impossible to make use of a tax

which, in the present juncture, offers the only visible prospect of supplying a substantial revenue with a minimum of strain and inconvenience to the taxpayers.

It was noted above that the stock objection of regressiveness was brushed aside, as it should be. What, however, shall be said of the small-income group?

To begin with, no one knows anything about the size and the location of this group. It is no doubt true, as a matter of income statistics, that there are persons, somewhere, receiving annual incomes at some point all the way up the scale from $1. In these days the number who are receiving less, say than $500 a year is probably small. At any rate, such families as may be in that income status are doubtless also getting relief in some form.

It is curious that there should be such concern over the effect of the sales tax on the small income, and at the same time such zeal for an increase of the social security pay-roll tax, which takes no account of income, family size, or personal obligations. The person earning $500 a year would pay $30 in social security tax at the rates proposed in the Wagner-Murray bill. After such a person had paid his rent, his expenditures on taxable consumption goods could not greatly exceed $300, so a 10 per cent sales tax would approximate the social security tax. Against the remote benefit that he expects from the one tax can be set the immediate benefit of reduced inflationary pressure and a smaller public debt, which will be an important factor in determining the value of his future social security benefit.

From the emphasis that has been laid on this group, so vague as to size and location as to be almost an abstract statistical concept, it appears that we are in some danger of deciding an important fiscal question by reference to its effect on the indigent. Certainly, the great bulk of the people can bear a sales tax; certainly they can pay an additional tax more easily in this way than by further increases in the complicated income tax. If an adjustment of some sort is necessary on the basis of need, by all means let it be made. But it should be confined to those who need it and determination of the cases should be a responsibility of the local welfare departments. There should be no exemption to those who are not in need, either of a fixed amount or of classes of consumption goods.

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THE TAX POLICY LEAGUE

Luxury Taxes

THE arguments presented in the previous selections concern a sales tax more or less general in scope. Sales taxes may also be applied to the exchange of particular commodities. Here the most popular subjects for selection are the so-called "luxuries," taxes upon which are discussed below.*

It frequently happens that legislators, or laymen interested in public affairs, in casting about for new sources of revenue hit upon what seems at first glance the happy idea of a tax upon luxuries.

Parenthetically it may be remarked that few persons other than tax economists seem to have any awareness of how painfully limited are the productive sources of revenue and that in the final analysis all taxes constitute property or income levies. A great mass of these taxes, however, are camouflaged under the names of excise, gross receipts, general sales, and turnover taxes and similar nomenclature. Their effect is obscured and their incidence concealed so that the citizen is taken unawares and feels that this great flock of hybrids constitutes alternate sources of revenue which in some mysterious way broaden the tax base and relieve property and income from heavy burdens. This is merely an ostrich-like refusal to face facts. There are logical grounds in defense of certain excises but broadening the tax base thereby is a bit of deceptive nomenclature.

The luxury tax idea is appealing because it seems to indicate that the very wealthy will be taxed upon superfluous extravagances, such as yachts, diamond bracelets and orchids, and that the hardworking lower and middle classes will be correspondingly relieved. Such a picture is entirely erroneous. As in so many tax instances the name is not what it seems. The only luxury taxes that justify the cost of administration are those that burden the poor and leave the wealthy practically unscathed.

The trouble with a luxury tax starts with the definition. As can be seen from the dictionaries the term is usually applied relatively and subjectively. The writer once heard a great American professor of political science say that he could conceive of no act which under every imaginable circumstance could always be considered wrong. It is equally impossible to think of any one item of expenditure which could always be classed as a luxury.

* *Tax Policy*, IV, No. 4 (February 1937), 1–4. Reprinted by permission of the Tax Institute, New York.

The subjective quality of the term is indicated by the following dictionary definitions.

"A free indulgence in costly food, dress, furniture or anything expensive which gratifies the appetites or tastes; also a mode of life characterized by material abundance and gratification of expensive tastes. . . . Anything which pleases the senses and is also costly, or difficult to obtain; an expensive rarity; as silks, jewels and rare fruits are luxuries. . . . An experience, usually of a mental or emotional sort, which is marked by exclusiveness, lack of utility, and usually intense pleasure; . . . Anything productive of great pleasure or enjoyment." [1]

Economists have defined luxuries as follows:

"The word *luxury* taken by itself in an absolute manner is not significant and really means nothing more than the enjoyment of the superfluous; that is, one can get along without what is not absolutely necessary. This is the significance of the word *superfluity;* it is defined as anything not a necessity." [2]

"By necessaries I understand not only the commodities which are indispensably necessary to the support of life, but whatever the custom of the country renders it indecent for creditable people even of the lowest order, to be without." [3]

"Luxuries may be defined as all economic goods that are not necessities." [4]

"Every expense that is unnecessary." [5]

Most definitions of luxury hinge upon the social and economic status of the individual, but such definitions are valueless for the legislator framing a tax law. The law cannot be adjusted anew to every individual to whom it applies, but must be framed in such a way as to be interpreted alike for all classes in the political jurisdiction in which the tax is levied.

According to many of these definitions a $500 car would be a luxury to a man of very low income whereas one costing several times that amount would not be considered luxurious for the millionaire. It would be obviously unthinkable to tax the poor man's Ford as a luxury and exempt the millionaire's Rolls Royce as an essential. Therefore, the legislators in framing a luxury tax must arbitrarily designate certain items as luxuries and these items will be so taxed without regard to the economic status of the various taxpayers.

A study of the designations set forth in some of the various luxury tax measures proposed or enacted proves illuminating. About a hundred years ago we find an official of the Province of New Mexico setting forth that "Every time that a man embraced his wife he would have to report the fact and pay a luxury tax and there would be spies and agents to see that the law was enforced." [6]

Almost equally amusing and preposterous was the designation of such items as brooms, lamps and mattresses as luxurious in the recently

[1] *Webster's New International Dictionary,* 1913, p. 1287.

[2] G. M. Butel-Dumont, *Theorie due Luxe* (1771), p. 121.

[3] Adam Smith, *Wealth of Nations* (New and condensed ed., 1903) Book V, Chap. II, Art. 4.

[4] H. R. Seager, *Introduction to Economics* (1904), p. 73.

[5] Werner Sombart, *Studien zur Entwicklungsgeschichte des Modernen Kapitalismus* (1913).

[6] Harvey Fergusson, *Rio Grande,* p. 191.

enacted Louisiana law. If only those objects which appeal to the popular mind as luxuries and which can be indulged in only by the wealthy were to be taxed as luxuries such a tax could be easily evaded and would also prove unproductive. There are relatively few persons in the market for diamond bracelets or steam yachts and the purchaser can readily evade payment of a tax by crossing state lines or even perhaps national boundaries if the levy is a Federal one. For practical purposes, therefore, certain items of consumption must be selected which are indulged in by the masses.

The items which are most usually designated as luxuries in our luxury tax legislation are liquors, admissions, tobacco products, cosmetics, playing cards, soft drinks and confections. Such taxes are frequently referred to as "nuisance taxes" in street corner parlance. At least in the early days there was a strong suggestion of puritanism in singling out some of these expenditures for particular tax burdens. Such expenditures were considered non-essential and to some extent harmful, and if the tax decreased consumption of them then so much the better.

That feeling does not seem prevalent today (even in the case of liquor it is becoming apparent that high taxes stimulate bootlegging rather than decrease consumption), although it has no doubt left some traces in present day sentiment.

Some of the most outstanding recent examples of luxury tax legislation are the Federal manufacturers excise taxes of 1932 (generally referred to as the "nuisance taxes"); the Kentucky Luxury Tax Act of 1936; and the Louisiana Luxury Tax Act also of 1936.

Federal Nuisance Taxes

The Federal Act covered automobile bodies, parts and accessories, brewers' wort and malt, cameras, candy, chewing gum, firearms, shells and cartridges, furs, gasoline, grape concentrates, electrical energy, jewelry, lubricating oils, matches, mechanical refrigerators, radio receiving sets, soft drinks, sporting goods, tires and tubes and toilet preparations. Ad valorem rates of 2 per cent to 10 per cent were levied on most of these objects. Gallonage charges of 1¼ cents to 20 cents a gallon were made on the beverages.

Considerable revenue has been realized from some of these excises. They have proved unpopular, however, and have been somewhat modified. The tax on jewelry was repealed and the tax on furs was reduced from 10 per cent to 3 per cent in 1936. It was claimed by some dealers that a diamond boom followed the repeal of the jewelry tax.[7] The toilet goods industry is working out comprehensive plans to seek removal of the Federal nuisance tax on toiletries. It has been rumored that such of these Federal excise taxes as yield scarcely more than the cost of administration will be repealed in 1937.

[7] *East Side Chamber News,* July, 1936.

COMMITTEE ON INTERGOVERNMENTAL FISCAL RELATIONS

Advantages of Federal Administration in the Tobacco Tax Field

SOME of the special problems involved in the state and federal taxation of tobacco are discussed in the next selection.*

(*a*) *Development and Status of the Federal Tax*

Although the Federal Government made some temporary use of the tobacco tax at the time that Alexander Hamilton was struggling with the problem of State debts, it was during the Civil War that the tobacco tax became a permanent feature of the Federal tax system.

The impressive increase in cigarette consumption during the twentieth century has had a marked effect on tobacco taxation. Per capita consumption was only 35 cigarettes per year in 1900, but by 1941 the number reached 1,427. In 1900 less than 7 percent of the Federal tobacco taxes was collected from cigarette consumers, but by 1940 the proportion had increased to 88 percent.[1]

Total Federal collections for the several tobacco taxes increased from $59 millions in 1900 to $698 millions in 1941. Since July 1, 1940, the tax rate has been 6½ cents on a standard package of 20 cigarettes, 18 cents per pound of manufactured tobacco, and from $2 to $13.50 per thousand cigars.[2]

(*b*) *Development of State and Municipal Tobacco Taxation*

The taxation of tobacco by States has been a comparatively recent development but it has advanced rapidly in recent years. State tobacco taxation began in Iowa in 1921. Early State laws were strongly imbued with the objective of discouraging the consumption of "coffin nails" by the "cigarette fiend." The early laws were regarded as substitutes for outright prohibition, then in operation in some States. Although this early interest in cigarette taxation has been largely abandoned, it has been replaced by a strong fiscal interest. By 1931, the number of States taxing tobacco had increased to 14 and during the next decade the number more than doubled, making a total of 29 in 1941. Montana repealed its tax in 1939 but Illinois and Maine joined the procession during 1941. The important revenue-raising States, New York, Massachusetts, Illinois, and Wisconsin, are all recent

[1] Compiled from Treasury Department, Annual Reports of the Commissioner of Internal Revenue.

[2] *Ibid.*

* *Federal, State, and Local Government Fiscal Relations*, pp. 497–503.

arrivals in the field. Undoubtedly the trend toward tobacco taxation during the 'thirties was accelerated by the depression, but it is probably a secular movement as well as a depression phenomenon.

* * * *

Cigarette taxes in general were adopted first by the agricultural States, especially the Southern States. Since 1935 there has been a distinct tendency for the nonagricultural States to adopt the cigarette tax; all the Eastern States from Pennsylvania to Maine adopted cigarette taxes during this period.

In fiscal terms, the tobacco taxes are much more important to the Federal Government than to the States. They rank tenth as State revenue producers.[3] However, they are increasing in importance. State collections increased from $11 millions in 1931 to $107 millions in 1941. These taxes are regarded by the States as an excellent supplementary revenue source, and, from the fiscal standpoint, they have the advantage that their yield holds up well during depressions. In 1940 New York with collections of $22 millions, and Pennsylvania with receipts of $12 millions, obtained the largest sums from tobacco taxes; the former received 9.4 percent and the latter 9.1 percent of State revenues from tobacco. In Mississippi only the gasoline tax and sales and use tax exceeded the tobacco tax in relative fiscal importance.[4]

The measure of the State cigarette taxes is normally volume, expressed either in packages of a specified size or in the number of cigarettes. In this respect they resemble the specific excises of the Federal Government. For example, the recently adopted Illinois tax is 1 mill on each cigarette; in Alabama, the tax is 3 cents per package of 10 to 20 cigarettes. Only two States do not measure the cigarette taxes in specific terms. Kentucky's cigarette-tax rate is 1 cent on each 10 cents or fraction thereof of retail price; New Hampshire's tax on all forms of tobacco products—adopted as a substitute for the State property tax—is 15 percent of the retail price. All nine States levying cigar taxes graduate the tax according to the retail price of the product. With few exceptions, the State taxes on other forms of tobacco products are measured according to the retail price of the commodity.

A majority of the States reserve tobacco-tax revenues for State general funds. However, a few States have specifically dedicated the revenues for other purposes. For example, Arizona uses the revenues for social-security purposes; Alabama and Arkansas for schools; Georgia, in part, for Confederate pensions; Kansas, in part, for county purposes, and so on.[5] Despite these and other exceptions it is generally true that the revenues from State tobacco taxes are not tied to particular functions of government.

(c) *Advantages of Federal Administration; Impediments to Efficient State Administration*

The Federal Government has the important strategic advantage in tobacco-tax administration that it can

[3] Tax Institute, *Tax Yields, 1940*, p. 48.

[4] Tax Institute, "Tobacco Taxes," *Tax Policy*, IX, No. 1, 4–5.

[5] *Proceedings of the Fifteenth Annual Convention of the National Tobacco Tax Conference* (Chicago: Federation of Tax Administrators, 1942), pp. 30–35.

collect from the manufacturer with little expense and small chance for evasion. The tobacco-manufacturing business is concentrated in the hands of an extremely small number of companies.

The number of manufacturers in business at the end of 1940, and from whom the Bureau of Internal Revenue collected taxes, is shown in table 69. The State of New York alone deals with almost 10 times as many taxpayers in collecting its cigarette tax as does the Bureau of Internal Revenue in collecting the Federal cigarette tax.

TABLE 69

NUMBER OF TOBACCO MANUFACTURERS IN THE UNITED STATES, DEC. 31, 1940 [6]

Types of manufacturers	Number of companies
Tobacco manufacturers:	
Plug tobacco exclusively	3
Twist tobacco exclusively	6
Fine-cut tobacco exclusively	3
Scrap chewing tobacco exclusively	99
Smoking tobacco exclusively	336
Snuff exclusively	16
2 or more kinds	111
Total	574
Quasi-manufacturing except perique	157
Perique producers and dealers	59
Total	790
Cigar and cigarette manufacturers:	
Small cigarettes exclusively	43
Large cigarettes exclusively	0
Small cigars exclusively	1
Large cigars exclusively	3,226
2 or more kinds	50
Total	3,320
Total tobacco manufacturers	4,110

[6] *Annual Report of the Commissioner of Internal Revenue, 1941,* p. 126.

The task of collecting taxes is even more centralized than the small number of companies in table 69 indicates. There were a total of 66 cigarette factories in the United States in 1940, but some companies operate more than one factory. A very large proportion of the cigarette taxes is collected from the "Big Four" companies; these companies are currently manufacturing the overwhelming majority of cigarettes produced in the United States. The cigarette taxes paid in the calendar year 1940 by 7 plants in North Carolina and 9 plants in Virginia amounted to $466 millions, or over four-fifths of the total cigarette taxes.[7] Thus it is evident that a manufacturer's tobacco tax levied by the Federal Government involves a minimum of direct taxpayers.

By far the greater part of these taxes, at least 90 percent, is collected through the use of stamps affixed to the taxable products.[8] Therefore the administration of the tax is simple and nontaxable tobacco is easily discovered. The taxes have been in effect for such a long time and the industry is so well organized and regulated, that the Bureau reports no major difficulty with respect to tax avoidance.

With only 4,100 taxpayers to deal with, the actual cost of collecting tobacco taxes is extremely low. For the fiscal year ending in 1941, the Bureau of Internal Revenue reported that the cost of collecting

[7] *Ibid.,* p. 122.

[8] Bureau of Internal Revenue, *Reports of the Miscellaneous Tax Unit Upon the History and Application of Various Miscellaneous Taxes* (1936), pp. 101–102.

$698 millions in tobacco taxes amounted to $1,241,285 or less than one-fifth of 1 percent (0.18 percent).

Because of the fact that the taxes cover the entire industry, changes in tax rates on tobacco have little effect on administrative expenses. To illustrate, lowering the personal exemptions for income-tax purposes means an increase in the number of taxpayers filing tax returns and hence a need for additional personnel. Increases or decreases in Federal tobacco-tax rates affect little, if any, the cost of tax administration.

In contrast to the very simple and easy task which confronts the Federal Government in the administration of its tobacco tax, the States have a much more difficult problem. The latter are obliged to collect from wholesalers, and in the case of purchases by retailers across State boundary lines, the collection must be from retailers. In the event of out-of-State purchases by consumers, reliance has to be placed upon the use tax with its notoriously difficult procedure.

State tobacco-tax administration is also relatively expensive. Administration is largely through the application of stamps by a more expensive process than that involved in Federal administration,[9] and one which often represents a substantial proportion of the direct cost of enforcement.[10] There is the additional State cost of examining goods to insure compliance with the tax. Still another factor explaining high State administrative costs is that States usually give discounts on the tax stamps to the tobacco merchants or wholesalers as an allowance for expense associated with the collection of the tax. Discounts range from nothing in a few States up to 10 percent of the value of the stamps. Alabama, Georgia, Mississippi, South Carolina, and Utah allow up to 10 percent; Arizona, Iowa, and Massachusetts make no allowance; Washington and Oklahoma allow 3 percent. An allowance from 5 to 10 percent is most common.[11]

A study of tobacco-tax collection statistics prepared by the Federation of Tax Administrators showed that the gross value of stamps and metering impressions in 20 States amounted to $77,887,810 in the fiscal year 1939; discounts for affixing these stamps amounted to $5,580,767, or 7 percent of gross collections.[12] These discounts alone amounted to more than four times as much as the entire cost of administering all the Federal tobacco taxes. New York's discount of $1.5 millions was approximately $500,000 more than was spent in administering the Federal tobacco taxes in 1941.

There is an abundance of evidence, though not very specific, that evasion and avoidance of State tobacco taxes constitute a serious problem. The nature and techniques of evasion were described in a report prepared by the Committee on Interstate Evasion, National Tobacco Tax Conference.[13] On the basis of this

[9] The Federal stamps may be inserted inside of the outer wrapping.

[10] J. W. Huston and J. R. Berryman, "Collection and Enforcement of State Consumption Excise Taxes," *Law and Contemporary Problems,* VIII, No. 3 (Summer 1941), 517.

[11] *Proceedings of the Fifteenth Annual Convention of the National Tobacco Tax Conference* (1941), pp. 30–37.

[12] Committee on Standard Practices of the National Tobacco Tax Conference, *Uniform Tobacco Tax Collection Statistics* (Chicago: Federation of Tax Administrators, Research Bulletin No. 59, 1940), p. 4.

[13] Preliminary Report of the Committee

study, Clyde Reeves estimated that losses through evasion alone were as high as 20 percent of what should have been collected had there been complete coverage. In explaining the evasion, he said, "It is these millions that make profitable the far-flung systematic operation of tax-dodging artists dipping into each cigarette-tax State." [14]

The interstate sale of cigarettes is perhaps the most important method of evading State cigarette taxes. The method of operation is to set up a wholesale cigarette establishment, preferably but not necessarily in a State without tobacco taxes, just across the line from a tobacco-tax State. Agents are then hired to solicit direct orders from consumers in the tobacco-tax State. Prices quoted are usually less than the customary retail price since the State tax is not added. The result is that the consumer makes a substantial saving, especially if he buys in quantity. The cigarettes are shipped either in bulk to the agent and then distributed to the consumer or, in a growing number of cases, are shipped by parcel post directly to the consumer. In some States greater complexity is gained by bringing in a third State; the sale occurs in one State, the shipment is made from a second State, and goods are billed from a third.[15]

In 1939 the Federation of Tax Administrators [16] published a summary of the cigarette tax evasion problem as it existed at that time, a part of which is quoted below:

> Because of the very nature of the evasion process, no accurate figures are available to show how big the leak in tobacco tax administration really is. However, estimates of losses have been made by administrators in at least seven States.
>
> Mr. N. E. Shuffield, supervisor of the cigarette tax division, department of revenue, State of Arkansas, estimated that as a result of parcel-post shipments from other States Arkansas lost about $300,000 during the year, as against a total collection of $1,305,000 in 1937. It has been estimated that the State of Georgia loses over $400,000 per year, as against a total collection of $1,512,000 in 1936. Mr. E. F. Rahm, superintendent of the cigarette revenue department, treasurer's office, State of Iowa, reported that Iowa was losing as much as $1,000,000 for the year 1938 and was collecting only about $1,750,000, with most of the loss arising from interstate evasion. Mr. Paul M. Minus, director of the license tax division, State tax commission, South Carolina, reported in February 1938 that interstate parcel-post shipments of tobacco products to retail dealers alone is causing the State of South Carolina an annual loss of approximately $150,000, as compared with a total collection of $2,218,000 in 1937.

The States have attempted to meet this and similar forms of interstate tax evasion by cooperative efforts, by the enactment of use taxes, and by securing the support of tobacco manufacturers and wholesalers. Despite these attempts, the States have been unable to cope with the interstate problem effectively.

While quantitative data are mostly estimates, it would be conservative

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on Interstate Evasion of the National Tobacco Tax Conference, *Tobacco Tax Evasion Through Interstate Parcel Post Shipments* (Chicago: Federation of Tax Administrators, Research Report No. 6, 1939).

[14] H. Clyde Reeves, "Progress Toward Elimination of Cigarette Tax Evasion," *Proceedings of National Tobacco Tax Conference, 1939,* p. 11.

[15] *Ibid.,* p. 4.

[16] Committee on Interstate Evasion of the National Tobacco Tax Conference, *Tobacco Tax Evasion Through Interstate Parcel Post Shipments,* pp. 1–2.

to conclude that the State tobacco tax is only 75 to 80 percent effective. The balance is represented by cost of stamps, discounts, other administrative expenses, and evasion.

The evasion is objectionable not only because of the loss of revenue; it involves discrimination and makes a group of petty lawbreakers out of individuals who purchase tobacco by mail and evade the use tax. The legitimate tobacco merchant also faces destructive competition from those who specialize in circumventing (legally or illegally) the State tobacco taxes. The elimination of these elements of discrimination should have a distinct appeal to the tobacco trade.

(*d*) *Other Aspects of the Tobacco System*

Two other aspects of the tobacco tax system deserve comment. One is that the tax is quite regressive in character. Consumption of tobacco in the United States is no longer confined to persons of high income; the product is consumed by forty to fifty million people. The following examples show the amount of the cigarette tax burden on cigarettes in some of the States:

(1) On a package of cigarettes in Arkansas, Louisiana, and Oklahoma, a total tax of 11½ cents is paid, consisting of the Federal tax of 6½ cents and the State tax of 5 cents. In these States, the package-a-day smoker pays an annual Federal tax of $23.73 and a State tax of $18.25, or a total of $41.98.

(2) In Alabama, Georgia, North Dakota, South Carolina, South Dakota, Tennessee, and Texas, the package-a-day smoker annually pays total Federal and State taxes of $34.68, the latter at 3 cents per package.

(3) In 18 States—among them New York and Illinois—the total cigarette tax is 8½ cents per package; in these States the package-a-day consumer pays annual State and Federal taxes of $31.03.

Somewhat similar situations apply to cigars and other forms of tobacco consumption. For example, in Mississippi, a 5-cent cigar bears a State tax of 1 cent and a Federal tax of 2 mills or a total of 1⅕ cents. In this State a cigar smoker using 6 cigars a day would pay a total Federal and State tax of $26.28 a year.

On the assumption that tobacco taxes are completely shifted to consumers, they comprise a heavy burden on the low-income groups, and are probably quite regressive. Although low-income consumers do not spend as much for tobacco as do more prosperous consumers, since the former purchase the cheaper types of tobacco products, we know that tobacco purchases are a significant expenditure for all income groups.

The second aspect to be noted is that the Federal cigarette tax and all but two of the State taxes are specific taxes; that is, they apply to the quantity and not the quality or price of the cigarettes. As matters now stand, the specialty, custom-made, and standard brands bear no higher tax than the 10-cent brands. The Treasury has recommended a differentiation in tax on the basis of price classification. In addition, the States, as previously indicated, discriminate widely and heavily against the cigarette smoker as compared with the consumer of other forms of tobacco. Little can be said for this discrimination, except perhaps that there is hesitation in applying a tax to a com-

modity the consumption of which is waning. From the standpoint of ability to pay, the cigar smoker is at least as able to support the government as the cigarette smoker—and usually more so.

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ROBERT S. FORD AND
E. FENTON SHEPARD

Retail Sales Taxation in Michigan

IN THE United States, taxes on general retail sales are used principally by the states, about half of which apply such levies. This practice originated in most instances during the depression of the thirties. A typical case is that of Michigan. The mechanics and some of the problems of the Michigan tax are discussed below.*

The retail sales tax plays an important part in financing government in Michigan. Adopted nearly eight years ago as an emergency measure to provide funds for welfare relief and tax relief for real estate, it has helped to support and expand the system of state aid to local units, particularly for the public schools, and has therefore become important in the financing of local government. The Michigan sales tax has produced more than $50 million annually since 1936, and, as a source of state and local revenue, ranks next to the property tax levy which amounts to about $165 million.

Contrary to popular belief, the sales tax is not easy to administer. In the seven and one-half years of its operation, many perplexing problems of an administrative and legal character have arisen, and a number of changes have been made in the law. One of the most important was the revision in 1935 to authorize the exemption of sales of goods to be used in industrial processing or agricultural production in order to prevent pyramiding of the tax. Another significant change was the adoption of the use tax in 1937 as a means of taxing out-of-state purchases which were exempt from the sales tax.

With the sales tax affecting all consumers, it is important that there should be a broad understanding of its nature and operation. Furthermore, various proposals are being made currently for alteration of the

* Bureau of Government, Michigan Pamphlets No. 12, University of Michigan, 1941 (adapted).

law. This pamphlet has been prepared to furnish citizens with basic information concerning the nature of the sales tax, its fiscal results, administrative organization and problems, and some of the chief issues that are now being discussed.

REASONS FOR ADOPTION IN MICHIGAN

Among the most pressing reasons for the adoption of the sales tax in Michigan was the necessity of finding additional revenues by which to counteract the general decline in existing state and local property tax yields. Prior to 1933 both state and local governments relied heavily upon the property tax. In the fiscal year 1930 the total property tax levy amounted to about $267 million, but by 1933 it had declined to $159 million; this was caused by the decline in assessed valuations during the depression and by the adoption of the constitutional fifteen-mill rate limitation. The depression also gave rise to a widespread and exceptionally large tax delinquency, and actual tax collections were much lower than the property tax levy. Furthermore, there was a substantial decline in revenues from other state taxes, especially the ad valorem tax upon railroads and other centrally assessed utilities, the annual corporate privilege fee, and the motor vehicle weight tax.

A second factor which was responsible, in part, for the adoption of the sales tax was the necessity for state participation in the financing of welfare and relief costs. Unemployment became so widespread during the depression that the costs of emergency relief quickly surpassed the ability of the local units to finance them. Accordingly, the state, with the aid of grants from the Federal Government, was forced to assume a share of the costs of this expanding governmental function.

To cope with the critical fiscal situation of the state and local governments, the 1933 legislature adopted a number of tax measures. Among these new levies, in addition to the sales tax, were taxes on liquor, chain stores, and horse racing. A tax on personal income was also considered but was defeated largely because of doubts as to its constitutionality.

TYPES OF SALES TAXES

When adopting the sales tax, the legislature was faced with a choice of several different types. Selective sales taxes on particular commodities, such as tobacco, gasoline, and alcoholic beverages, have been imposed for many years by the Federal Government and a number of states, but, prior to 1933, general sales taxes were somewhat of a novelty. The term "general sales tax" refers to flat-rate taxes imposed upon commodities or transactions in general, measured by the gross proceeds therefrom. There are several different types of general sales taxes although there are no clear-cut distinctions between them.

The most inclusive is the gross income tax, such as in Indiana, which places a tax upon the gross income from all business transactions, including the sales of real and personal property, wages, salaries, rent, interest, and dividends. A second type is the gross receipts tax, like that in Mississippi, which is applicable to all business transactions, including receipts for professional services, but excluding wages and other personal income. A third and more limited type of tax is the so-called general sales tax on manufacturers, whole-

salers, and retailers, which excludes professional and personal services. The Arizona tax is similar to this type and is so designated, although it does not apply to wholesale transactions. Finally, there is the retail sales tax which is levied primarily on the sale of tangible personal property at retail.

NATURE OF RETAIL SALES TAXATION

The retail sales tax is generally regarded as falling on the consumer. Actually it is difficult to determine precisely the extent to which this occurs because there may be instances where the tax is absorbed by the retailer or shifted backward to the agents of production; this is true whether the sales tax is collected separately from the selling price of the product or simply included in the merchant's costs of doing business.

Although the retail sales tax is intended as a proportional tax on consumption, the amount of consumers' expenditure which is taxed depends on the scope of the tax base and the number of exemptions allowed. In Michigan the tax applies to the sale of tangible personal property at retail and to the sale of electricity and gas. Accordingly, the tax does not apply to expenditure on such items as personal and professional services, housing, travel, and most amusements and recreational services. Furthermore, as personal income increases, a smaller proportion is spent on taxable articles. Being applicable to only a part of consumer expenditure and imposed without regard to personal economic status, the retail sales tax is regressive and bears more heavily upon persons with small incomes than upon those with large incomes.

GENERAL FEATURES OF THE MICHIGAN SALES TAX

The Michigan three per cent sales tax is based upon the privilege of selling tangible personal property at retail and is measured by the gross proceeds of such sales in cash or credit. Michigan, like several other states with this kind of tax, treats public utility services to the ultimate consumer as taxable sales. Although the retailer pays the tax to the state, it is the intention of the legislature, as clearly expressed in the act, that the tax is to be borne by the purchaser or consumer. Under the act, the seller is authorized to add the amount of the tax to the sales price, or he may quote the sales price and the tax separately. In any event, the seller may not advertise "or hold out to the public in any manner, directly or indirectly, that the tax is not considered as an element in the price to the consumer."

Neither the sales tax law nor the rules and regulations of the State Board of Tax Administration provide any official schedule of the amount of tax payments on small purchases. The Retail Merchants' Association of Detroit, however, prepared a schedule which is quite generally followed. This schedule is as follows:

Amount of Sale	*Tax*
Less than 17 cents	None
17 cents—49 cents	1 cent
50 cents—83 cents	2 cents
84 cents—$1.16	3 cents

Another feature of the Michigan tax is the $600 annual statutory deduction from gross sales. The deduction is allowed at the rate of $50 per month; and, if the seller is in business for less than a month, it is allowed on a fractional or proportional

basis. Other allowable deductions include: sales for purposes of resale; sales in interstate commerce; sales to the United States, the state, or any political subdivision thereof; sales for consumption or use in industrial processing or agricultural production; sales of specially ordered commercial advertising; sales to schools, hospitals, churches, and other similar, nonprofit agencies; sales of books and foods to students by bona fide educational institutions; and a few less important deductions.

THE MICHIGAN USE TAX

Sales in interstate commerce are exempted from the provisions of the sales tax act primarily because of judicial interpretation of the commerce clause of the Federal Constitution, which traditionally has held that sales in interstate commerce were not taxable by the states. The existence of such an exemption, however, gives the out-of-state seller a competitive advantage over the merchant doing business within the state. As a result, Michigan and fifteen other states have adopted what is known as the "use" tax.

The Michigan use tax is imposed on the consumer as an excise tax for the privilege of using, storing, or consuming tangible personal property purchased at retail. Intended as a supplement to the sales tax, the use tax is imposed at the same rate, namely, three per cent of the purchase price, and allows an exemption of all goods which are taxable under the sales tax law. Thus, the use tax, in effect, applies to goods purchased at retail in interstate commerce for use, storage, or consumption in Michigan. The tax is administered by the State Board of Tax Administration, the same agency which is charged with the administration of the sales tax.

The constitutionality of the use taxes of California, Iowa, and Washington has been upheld by the United States Supreme Court, and the Michigan use tax has been validated by the Wayne County Circuit Court. Nevertheless, it is very difficult to enforce the tax especially upon small sales. Purchases outside of the state of large items of tangible personal property, such as automobiles, refrigerators, or equipment for business are fairly easy to trace; but small purchases and mail-order sales are practically impossible to discover. Consequently, although the Michigan consumer is liable for the use tax, an attempt is made to have the out-of-state seller report and pay to the state the use tax due by collecting it from the consumer at the time of sale. Again enforcement is difficult, for the state appears to have no jurisdiction over the out-of-state merchant unless he maintains an office or agency within the state.

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Method of Collection

In some of the retail sales tax states, such as Ohio, where the tax is levied upon the transaction or act of sale, the consumer is legally liable for the tax, and the retail merchant or other seller serves as the tax collector for the state. In Michigan, however, the tax is imposed upon the seller for the privilege of doing business at retail. Because a retail sale is defined as a sale for ultimate use or consumption and not for resale, manufacturers and wholesalers are also designated as retailers whenever they sell directly to the ultimate consumer.

To facilitate the task of adminis-

tering the act, all persons or firms engaged in making sales to consumers are required to obtain an annual license from the State Board of Tax Administration, for which there is a charge of one dollar. Taxpayers are required to file monthly tax returns on forms provided by the state board, together with the necessary tax payment, on or before the fifteenth day of the following month. Failure to comply with these or other provisions of the sales tax law may be punished by a fine of not more than $1,000, or imprisonment in the county jail for not to exceed one year, or both. The state board also has the right to revoke the license of any taxpayer who violates the law, but it has seldom exercised this power.

Administrative Problems

Most of the difficulties encountered in the administration of the sales tax are traceable to the problems of defining a taxable retail sale, of minimizing evasion, and of avoiding conflicts with the constitutional limitations upon the taxing power of the state.

Sale at Retail

In general, the sales tax applies to all sales of tangible personal property to a consumer for use or consumption and not for resale. Therefore, sales of goods which, as ingredients or constituents, go into and form a part of tangible personal property for resale by the buyer are not taxable. A difficult problem has arisen, however, in the case of sales of goods for use in carrying on the business which do not become a component part of the finished product, such as machine tools. At first, goods purchased for use in business were held to be sales at retail and therefore taxable. But, in order to prevent pyramiding of the sales tax to the consumer, the act was amended in 1935 to provide for the exemption of goods purchased for use in industrial processing or agricultural production.

Industrial Processing

As the industrial processing exemption is now interpreted, sales of tools, dies, patterns, machinery, oil, grease, gas, coal, coke, electricity, and other items which are used directly in the manufacturing process or within the processing department, are not taxable. On the other hand, sales of tangible personal property which becomes a part of or affixed to real estate, such as fixtures and pipe fittings, are taxable; and sales of equipment, materials, and supplies for use in general administrative and distributive departments, such as executive, advertising, sales, purchasing, maintenance, receiving, and shipping departments, are also taxable.

Agricultural Production

Sales of goods to farmers to be used in producing agricultural commodities for sale are exempt from the tax. Such goods are taxable, however, if they are to be used in producing goods for consumption by the farmer. In addition, tangible personal property that becomes a part of the real estate, such as a silo or windmill, is taxable.

Public Utilities

Public utility services are not ordinarily regarded as tangible personal property. Nevertheless, the Michigan law contains a provision for the taxation of sales to consumers of electricity, natural or artificial gas,

and steam, and for the exemption of the sale of water delivered through water mains. Telephone, telegraph, and transportation services, however, are not taxable under the act.

Although sales of gas and electricity by privately owned utility companies have always been included in the scope of the tax, the question arose as to whether sales by municipally owned plants were also taxable. When the State Board of Tax Administration sought to tax these sales, the matter was contested in the courts. The Michigan Supreme Court held that sales by municipally owned utilities were not taxable on the ground that the terms "sale at retail" and "person" in the act did not specifically include sales by municipally owned plants. In view of the unfair discrimination between consumers of publicly owned and privately owned utility services, the legislature in 1939 amended the definition of persons taxable to include any "municipal or private corporation whether organized for profit or not." The constitutionality of this provision has been upheld by the Michigan Supreme Court, and all sales of gas and electricity to the consumer are now taxable.

Tax Evasion

Of major importance in the administrative task is the problem of preventing evasion. Very little is known about the amount of evasion from the sales tax, but the very fact that the tax is highly productive has not stimulated adoption of the most efficient administrative methods. A great deal of the evasion can be prevented by plugging loopholes in the law itself. The 1939 legislature amended the sales tax law in several instances in order to prevent evasion. For example, the law now provides that the state board may require a surety bond of not less than \$1,000, nor more than \$25,000, to be filed by any applicant taxpayer who has previously failed, refused, or neglected to pay any tax, interest, or penalty due the state, or who has attempted to evade payment of the tax by means of a petition in bankruptcy. This provision would be still more effective if the administrative authorities were given power to require a surety bond in the case of any doubtful taxpayer rather than only those who have previously failed to pay the tax due. If this were done, so-called transient vendors, who are in the state but a short time, and seasonal merchants could not evade payment of the sales tax.

To facilitate the collection of unpaid sales tax from taxpayers who have gone out of business, a 1939 amendment provides that the sales tax shall constitute a prior lien upon the business assets of the taxpayer; that is, the sales tax lien takes precedence over ordinary liens such as chattel mortgages and conditional sales contracts. The proceeds from the sale of business property are applied pro rata to the satisfaction of any tax lien.

As a means of minimizing evasion of the sales tax on purchases of motor vehicles, the legislature provided in 1939 for the collection of the sales tax on automobiles and trucks by the secretary of state. Before delivering any motor vehicle, the dealer must apply to the secretary of state, in behalf of the purchaser, for a registration or transfer of license, and the application must be accompanied by payment of the sales tax. No title or license plates may be issued until the sales tax has been paid.

Once the sales tax law has been carefully drafted so as to close all possible loopholes, the checking of evasion depends on the efficiency of the administrative machinery. No sales tax can be successful without careful enforcement of the penalty provisions of the law and an audit of the taxpayers' records at frequent intervals to determine whether the retailer is accurately reporting his taxable retail sales. In this respect, the Michigan administration appears to have been less efficient than that of some of the other sales tax states, such as California and Illinois, which have many more field men to audit taxpayers' accounts. In 1939 California employed 591 men in field administration; Illinois, 312; and Michigan only 197. It is now generally agreed that more funds should be spent on field administration and that the increased revenue which would result would be much larger than the added cost of administration. Furthermore, efficient administration is the only means by which fair and equitable treatment of all taxpayers may be achieved.

* * * *

Sales Tax and the Federal Income Tax

A good deal of interest has arisen over the fact that in some states sales taxes paid may be deducted in computing federal income tax returns, while in other states no deduction is allowed. This so-called discrimination is due to a legal distinction. In Ohio, where the sales tax is imposed on the transaction of sale, the consumer is liable for the tax; and he is allowed, therefore, to deduct the sales tax along with other direct taxes in computing his federal income tax. In Michigan the sales tax is in the form of a business privilege tax and the retailer is legally liable for the tax. Whether or not the tax is shifted to the consumer is of no consequence in determining its legal nature. Thus, the retailer, and not the consumer, is allowed to deduct the sales tax. The retailer in Michigan, however, must include the sales tax as part of his gross income for federal income tax purposes, whereas the vendor in Ohio does not include the sales tax as gross income.

It is frequently stated that substantial savings would be effected for income taxpayers if Michigan were to change to a consumer form of sales tax. It would seem, however, that the importance of such a change has been overemphasized. The bulk of consumers would be affected very little, or not at all, by the deduction because relatively few consumers file federal income tax returns.

The general question of deductions in computing federal income taxes is, of course, important; and the suggestion has been made that it would be desirable to alter the federal income tax law to prevent the deduction of state sales taxes in computing taxable income. The reasons offered in support of this view are as follows: (1) the Federal Government is in need of all the revenue which it can obtain; and (2) deductions of this type are apt to operate inequitably because individuals will have to estimate their sales tax payments, and it would be practically impossible from an administrative standpoint to check such deductions. Nevertheless, so long as other states take advantage of this feature of the federal income tax, it is not surprising that similar action should be considered in Michigan.

Consumer Form of Levy

It is important to realize that to allow a deduction of the sales tax from federal income tax returns would necessitate the adoption of the consumer form of sales tax in Michigan. This would in turn require considerable revamping of the sales tax structure. The emphasis, under the consumer levy, is on exact tax collections from the consumer on every retail purchase. The retailer is also required to segregate sales tax collections from other business income. As a result there is generally some increase to the retailer in the costs of compliance with the sales tax law and added inconvenience for the consumer. In several of the states, tax tokens have been introduced to facilitate accurate collection of the tax, and other states allow the retailer a percentage deduction for his services as tax collecting agent. In Ohio prepaid tax receipts are used, not so much to make tax collection accurate on each sale—since the receipts are only in denominations of one, two, or three cents—as to insure tax payments from the retailer to the state and from the consumer to the retailer. The Ohio retailer is allowed a three per cent deduction for handling the tax receipts, which he purchases on a cash basis from the government prior to the sale to the consumer.

If the advantages of the consumer form of tax are deemed to outweigh the advantages of the business privilege tax, it would of course be advisable to change; but in making the decision it is well to bear certain facts in mind. First, the seven and one-half years of experience in Michigan with the business privilege type has established legal forms and administrative rulings which are familiar to both retailers and administrators. Although further improvements in administration are desirable, they can be achieved without changing the technical form of the tax. Adoption of the consumer levy would necessitate considerable change in forms and rulings with consequent delay in getting the new administrative procedure under way. Second, from the economic point of view, there is no significant difference between the two types of taxes. In the long run the incidence of both taxes is essentially the same. The provisions requiring exact collection from the consumer would result in uniform methods of tax collecting when the new tax is first adopted, but the ultimate burden of the tax depends on underlying economic forces. Third, the consumer form of levy is probably more costly to administer. There is additional cost of compliance for the retailer and inconvenience for the consumer. In addition it is generally urged that tax tokens or prepaid tax receipts be adopted, and that the retailer be reimbursed for serving as collecting agent—all of which should be regarded as costs of administration. If efficient administration is possible without these additional costs, it would seem unnecessary to adopt special tax-collecting devices. Fourth, the usual argument for the consumer levy—that it promotes tax consciousness—is equally applicable to the business privilege tax in Michigan in view of the practice of separate charging by the bracket system and the publicity given the sales tax.

Lump-Sum Exemption

Michigan is the only one of the sales tax states that grants a lump-sum exemption from gross sales, in

this case \$50 per month or \$600 annually. Presumably adopted to simplify administration, it has not had this effect because all retailers are required to send in monthly returns whether they pay a tax or not. These returns must be checked and the retailers' records have to be audited just as in other cases in order to determine actual tax liability. In addition, the \$50 exemption results in a loss of revenue to the state of about \$1,000,000 to \$1,500,000 annually.

The lump-sum exemption is sometimes regarded as a remuneration to the retailer for his services as tax collector. The monthly deduction from gross sales of \$50, which is equivalent to \$1.50 in tax, bears little relation to the merchants' costs of compliance, however, because it is based upon the assumption that all merchants have the same absolute amount of costs—\$1.50 per month. Furthermore, the costs of compliance, in the long run, are shifted to the consumer to the same extent as the sales tax itself is shifted.

Purchases by Business

As has been previously explained, the industrial processing exemption was adopted to prevent pyramiding of the sales tax, but not all articles purchased for use in business are exempt. For instance, equipment and supplies for use in general office work, or showcases and cash registers used by retail merchants in their business are taxable under the sales tax act. Because business costs, including the tax on equipment used in business, are in the long run included in the price of the product, the sales tax on goods used by business firms tends to be accumulated or pyramided to the consumer when the final product is subject to the sales tax. It was presumably for this reason that the report of the Tax Study Commission of January, 1939, recommended "that exemption be accorded for sales of equipment to be used in effecting retail sales from which revenue is derived" under the sales tax law. This is the practice in Ohio, and it represents an attempt to make the sales tax more nearly a tax on consumers' expenditure.

Food for Home Consumption

Several of the sales tax states exempt food or food products in order to reduce the regressive effects of the tax. California and Ohio exempt "food for home consumption." As has been indicated, such an exemption in Michigan would reduce the annual sales tax yield by approximately \$10,000,000. Although the administrative task would become more difficult because of the problem of defining the scope of the exemption and preventing evasion of the sales tax where legally payable, such an exemption should be considered when the state fiscal situation will permit.

Earmarking Sales Tax Revenues

Revenues from the sales tax are, in part, used to support state aid for education and welfare relief; and the proposal is frequently made for the adoption of a constitutional amendment earmarking a certain percentage of the sales tax funds for either or both of these functions. There are a number of arguments against the constitutional earmarking of public funds. In the first place, it renders the budget system of appropriation rigid and inflexible because the amount of money designated for specific functions is no longer left to the legislature but depends upon tax

collections. The yield of the sales tax fluctuates from year to year in response to general business conditions. In any one year, therefore, the amount earmarked may be more or less than is needed. Finally, there is also a tendency to earmark a larger percentage of the proceeds than may be necessary, with a consequent dearth of funds for other governmental functions.

Centralization of Tax Administration

It is now generally agreed that Michigan's heterogeneous system of tax administration would be much improved by the adoption of a coordinated plan of centralized tax administration, such as the proposal for a single department of revenue. This problem is of particular significance at present in view of the fact that a bill is being considered in the state legislature for consolidating the tax administrative agencies of the state. The importance of the sales tax in the fiscal system indicates that the administration of the sales and use taxes should be included in any reorganization of state tax administration.

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JOHN ISE

The Tariff

A TIME-HONORED but highly controversial means of raising revenue is the taxation of foreign trade. Objectives of such taxation include protection as well as revenue, and the former often predominates. Tariffs have never been popular with economists, one of whom presents the basis for his opposition, in part, as follows: *

After each country had found out how easy it was to tax itself rich by way of tariffs, each state of each country taxed itself rich the same way. Then the cities and towns of each state taxed themselves rich by the same way, and finally Mother taxed herself rich by putting a whopping duty on the roasting ears Pa brought home to cook, then Pa voted himself a two hundred per cent duty on the fur coat he bought for Ma's birthday, and—

* Reprinted by permission from *Economics* (New York: Harper & Brothers, 1946), pp. 348–349; 351; 355–356.

"G'wan, that's too silly for anything."

"Oh no! It's the economic philosophy of the two historic parties that govern this great and intelligent nation."

—OSCAR AMERINGER

On the problem of foreign trade and protection there is perhaps more rattlebrained thinking, or pretense of thinking, than on any other important economic question. It apparently is one question on which most Americans, and other peoples too, can be relied on to come consistently to wrong conclusions, declaiming sonorous nonsense about "keeping the money at home," "protecting American labor from the pauper labor of Europe," and "planting the factory down by the farm." Our faith in protection is much more a religion than an economic belief; indeed it is generally held more stubbornly than most religious tenets. Economists have properly devoted considerable attention to international trade and tariffs since long before the time of Adam Smith, and as a result of their studies they have been almost unanimously hostile to protective tariffs; yet the general public, in the United States and in most other countries as well, appears to be as strongly protectionist as ever. Although hundreds of books and thousands of articles have exposed the fallacies in most of the protectionist reasoning, the bankers and merchants and farmers go to the polls at every election and vote cheerfully for the "American system" which has brought us such wondrous prosperity. All of which is discouraging.

Advantages of Trade

The argument against protection may well begin with a review of the advantages of trade, domestic and international. Just as the total production of our economy is enlarged by occupational division of labor into carpenters, plumbers, farmers, electricians, and so on; just as the output of goods is enlarged by regional specialization—Kansas growing wheat, California producing oranges, Texas raising cotton—and by the exchange of goods among the different regions within a country; so does international specialization and free exchange of goods enable the world to produce more than it otherwise could. Free exchange of goods enables each country to devote its capital and labor to the production of the commodities in which it has the greatest comparative advantage, and so provides the maximum output for all. The policy of protection tends to deprive the people of all countries of the advantages of international specialization, and to reduce production and lower the standard of living everywhere. That is the general effect, just as surely as the standard of living in the United States would be lowered if trade among individuals were restricted and every man had to raise his own food, make his own shoes and clothing, and build his own home; just as surely as it would be reduced if interstate trade were prohibited and Kansas people could no longer buy California oranges and Michigan automobiles, and Rhode Island people could no longer buy Kansas wheat, Texas gasoline, and Pittsburgh steel.

The principle involved may be illustrated by imagining what would happen if the United States were to shut out all imported products that could possibly be produced at home. Many of the things we commonly enjoy would be so expensive and scarce

that few could have them. Bananas could perhaps be grown in Florida at very high cost; coffee might conceivably be grown in hothouses, but the supply would be so limited that only the rich could buy it; linen and silk could be produced, but at much higher cost than when imported; rubber substitutes are now being produced, but they are expensive and inferior to the imported natural rubber.

Suppose now that Kansas were to embark on a tariff program and to try to achieve self-sufficiency. She could produce a little cotton at high cost, but cotton clothes would be a luxury; by devoting more of her land to forests and using her own scanty and generally inferior lumber, she could build wooden houses, but they would be expensive and necessarily small; she could build some manufacturing plants, but except in flour milling and meat packing the small home market would permit only small plants, which would necessarily produce at high cost. Altogether, it is clear that her people would have to live rather primitive lives under such a program and that the state could support only a small proportion of her present population. Absolute prohibition of imports by a state like Kansas, or by any other state, would force the people to a life closely resembling barbarism.

It is thus apparent that protection, viewed broadly, is designed to reduce the amount of international trade and specialization, and so reduce the productivity of labor and the amount of goods available for consumers. Since under free trade labor and capital would seek those channels of production in which they were relatively most efficient, in which they would need no protection, it is clear that the demand for protection must come generally from the inefficient industries, those which cannot meet foreign competition. These are essentially "pauper" industries, asking for tariff "alms" in the form of high prices exacted from the people, to enable them to engage in lines of production in which they cannot support themselves. Most of those who damn the New Dealers for their generous relief policy do not realize that the first great relief program was the system of protection.

* * * *

Tariff Gains Enjoyed by Few People

Only a small percentage of the total population can possibly gain from a protection policy. The several million people who work in the retail and wholesale trade must lose, because the tariff reduces the amount of goods and raises prices, and therefore reduces the volume of sales. Professional and semi-professional workers—doctors, lawyers, preachers, teachers, dentists, barbers—can only lose, through scarcity and high prices of goods. Workmen in unprotected industries—building craftsmen, truckers, mechanics, day laborers, government employees, public utility employees, including the railroads—all these inevitably lose by protection. The railroads lose more than most other industries, because tariffs reduce the amount of traffic between the seaboard and the interior; and the railroad employees lose in two ways: in reduced opportunities for employment and in the higher cost of living. Farmers producing wheat and cotton and other export crops obviously gain nothing. On the contrary, they inevitably suf-

fer in two ways: from the reduction in the foreign market and from the higher cost of the things they buy. At the most, less than 10 per cent of the people in most communities can gain from protection, even in the short run. At best, such a tariff policy can be only a burden on at least 90 per cent of the people, for the benefit of the favored 10 per cent. And the gain, even for this small percentage, largely disappears in the long run. The only individuals who gain in the long run are the owners or stockholders of *monopolized* protected industries; even the laborers in these industries must lose, because in the long run they cannot receive more pay than laborers in other industries, and the general level of real wages is reduced by a tariff.

* * * *

The Tariff as a Tax

The tariff is not only a means of protecting home producers but a means of raising revenues, a tax. Many protectionists argue that the foreign producers pay the tariff; but while this may conceivably be true in very exceptional circumstances, in general it is the American consumers who pay it and a great deal more. The burden on them varies with conditions and circumstances, shading from one extreme, with the foreign producers paying the tariff and something in addition, to the other extreme, with American consumers paying an amount equal to the tariff and a great deal more, and the government receiving no revenue. The first extreme we cannot consider here because of the difficult theoretical problems involved. It is certainly uncommon or perhaps possible only theoretically.[1] A tight foreign monopoly selling almost all its output in the United States might perhaps be obliged to assume much of the burden of a tariff imposed by the United States, by lowering its prices to get over the tariff wall. The extent to which it would do this would depend not only on the availability of other markets for its product, but on possible sources of supply in other countries or in the United States; on cost conditions of the monopoly—whether increasing constant, or decreasing cost—and on the elasticity of demand in the United States. It is conceivable but hardly possible that the foreign monopoly would lower its prices enough to assume the entire burden of the tariff. The short-run and long-run situations would not be exactly the same.

At the other extreme is the situation in which American consumers pay all the tariff, or more. A tariff on coffee, tea, rubber, silk, or any commodity that is not produced here at all is ordinarily paid by American consumers, but with nothing added. The government receives as revenue all that the consumers pay, and there is no additional cost in capital and labor misdirected into inefficient channels. Great Britain long followed the policy of imposing tariffs only on such goods. When she imposed tariffs on imported goods which were also produced at home, she levied excise duties on the home industries to get the maximum revenues and avoid protection, a logical and consistent policy. When a country seeks customs revenues it should impose "revenue tariffs," with rates so low that goods would continue to be imported, because it is the im-

[1] See John Stuart Mill's classic exposition in his *Principles of Political Economy*, Book III, Chap. 18.

ports that pay the customs duties. To the extent that a tariff is protective, it must shut out imports, and therefore it can yield no revenues. There is thus a fundamental antithesis between protection and revenues.

A tariff on foreign goods which results in the establishment of a high-cost industry in the United States may impose on consumers a burden far greater, perhaps many times greater, than the amount of the customs duties collected by the government. The tariff on woolen goods is probably of this type. It brings in customs duties of about 6 million dollars, but costs consumers perhaps fifty or a hundred times that amount. Our sugar tariff was estimated to cost consumers 268 millions in 1930, for government revenues of only 115 millions. A tariff greater than the difference between domestic and foreign costs may lead to monopoly, as was the case in the steel and aluminum industries. Finally, a prohibitive tariff yields no customs revenue at all, yet may impose a very high cost on consumers. As a tax, such a tariff is the worst one imaginable, for it yields nothing, but raises prices, in some cases very considerably.

Tariffs as taxes are bad in other respects. Since they are not recognized as taxes by most consumers, who are blissfully unconscious of the fact that the high cost of many goods is due to tariffs, they have been used far too much. If in selling protected goods merchants were required to state separately the price, if imported free of duty, and the amount added to the price by the tariff, consumers would at least know how much they are paying to "keep their money at home." Suppose for instance, that a certain grade of clothing had to have a tag with the following information: "Price in England, $20; tariff tax, $15; total, $35." Would not consumers scrutinize tariff schedules more carefully and perhaps keep them within more reasonable bounds?

Tariffs as taxes are also bad because they are "regressive," that is, they bear most heavily on the poor and lower middle classes. A day laborer may buy as much sugar as Henry Ford (he really needs more), but under a sugar tariff he pays as much to the expenses of government as Henry Ford does; this means that, on the basis of his income, the rate he pays is more than a thousand times as high. It is scarcely surprising that some of the "robber barons" of the post-Civil War period piled up great fortunes, when there was no income tax and the federal revenues could be collected from the masses of the people through tariffs.

The Tariff on Sugar

An illustration of the tariff system at its worst may be seen in the sugar tariff. Here is a tariff which costs sugar consumers two or three times as much as it yields in revenue, for the protection of an industry which yields the farmer producers of cane and beets, as farm income, only about one-third as much as it costs consumers! In 1930, the cost of the sugar duties to consumers was more than the customs revenues plus the total farm income of the farmers who grew the beets and cane. In other words, if we had abolished the sugar tariff, we could have paid in taxes the amount of the customs revenues, could have paid the farmers as a pure bounty all that their crop would have been worth, without requiring them to do any work

whatever, and still saved some 50 million dollars—we could have kept all these farmers on relief for much less than the tariff cost. The sugar monopoly is the only group that gains anything from the high duties.[2]

But this is not all. Under the stimulus of the tariff, many farm communities in the West have turned from lines of production in which they were self-supporting to the production of sugar beets, using wretchedly paid Mexican or other foreign labor, children and women as well as men. The work is seasonal, and the total annual earnings are so small that the laborers live in deep poverty, many going on relief in the winter. In such communities, thanks to the sugar tariff, the fine democracy of the one-family farm is changing to an increasingly common form of American feudalism.

[2] See Lippert S. Ellis, *The Tariff on Sugar.*

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ALFRED G. BUEHLER

Taxing Consumer Spending

MUCH interest attended a proposal by the Treasury during World War II to inaugurate a graduated spendings tax. This is discussed by Professor Buehler in the following selection: *

In the financing of World War II, if we are to prevent disastrous inflation, a greater part of the cost of the war should be met out of taxation and especially out of taxes upon the expendable funds of consumers. Otherwise the surplus of consumer funds over available goods and services will bid up their prices as consumers with expanded incomes eagerly seek to exchange their rising incomes for much wanted items. By saving and producing more war materials and consuming fewer nonessentials which compete for labor, equipment, and material with war goods, we may more quickly and effectively convert our economy into an efficient war machine.

A few years ago it was our national policy to increase the flow of consumer spending and to fight oversaving and overinvestment. Now we are urging the people to invest in war bonds, pay off their debts, increase their savings, and sacrifice the consumption of articles which compete with the war effort. Now capital must be accumulated to finance the war, later it will be needed to finance the reconstruction of industry.

The restraints upon consumer

* *Bulletin of the National Tax Association,* XXVIII, No. 4 (Jan., 1943), pp. 123–128.

spending cannot be abandoned immediately after the war if a flood of inflationary purchasing power is to be withheld until the production of consumer goods and services catches up with the income paid out to consumers. We must expect heavy taxation of expendable funds to continue for some time after the war. The question is therefore pertinent, How shall we impose the new taxes upon consumer spending which are necessary to head off inflation and raise additional tax revenues?

Economists have sometimes bemoaned the inability of governments to tax consumer expenditures at graduated rates and have often criticized the regressive burdens of general sales taxes, which are particularly onerous upon the low incomes. When the Treasury startled the Senate Finance Committee in September with its spendings tax proposals, those who had prayed for a convenient and practicable tax upon expenditures at graduated rates may have wondered if this was the long-sought tax. Was this new light on the tax horizon a star which would shine steadily, or was it only the quick flash of a passing comet which would soon be forgotten?

The Senators and newspaper writers were bewildered by the Treasury's proposals. Was the suggested spendings tax a sales or an income tax, or neither? Would it not be much less convenient and much more complicated than a retail sales tax? Could the theoretical equity of the tax be realized if it were adopted? Would it not place additional heavy, and perhaps intolerable, burdens upon the backs of those who were already groaning under the load of the income tax? These and other questions were asked by legislators, economists, and others.

The Graduated Spendings Tax Defined

The term "spendings tax" was popularized in a proposal by Congressman Ogden L. Mills after World War I, with the encouragement of Dr. Thomas S. Adams and Mr. Chester A. Jordan, to substitute a graduated tax upon personal expenditures for the surtax. This would leave the normal tax as the only individual income tax. The Treasury had studied plans for lowering the surtax on savings out of income in relation to the tax upon expenditures from income. Before Mills introduced his spendings tax bill in Congress, Adams had come out with an argument for the conversion of the surtax into a graduated tax upon expenditures. In view of Adams' position as Tax Adviser to the Treasury and his acceptance as an outstanding authority on the income tax, his conclusions are worthy of study. Here we shall examine some of the problems of a spendings tax as a revenue.

A graduated spendings tax would be levied directly upon consumers, in conjunction with the net income tax. The basis of the tax would be the expenditures of the consumers, as defined according to legal requirements and reported to the government. The tax would be collected in much the same manner as the income tax. It would not, however, be an additional income tax. The Treasury is now advocating a spendings tax as a war revenue and an inflationary control. If the tax is sound in theory and is practicable of administration, it would also be useful during the post-war boom and

in other periods when tax pressure upon consumer spending would be socially and fiscally desirable.

The idea of a spendings tax is not new; it has been advanced many times during the last century in various countries and has been offered in various forms, sometimes as an alternative to all income taxation or only the surtax. Now the question before us is the possibility of employing a graduated spendings tax rather than a general sales tax or gross income tax. There is no longer any serious consideration, aside from Professor Irving Fisher and a few other economists, of substituting a spendings tax entirely for the income tax. After attempting a crude form of expenditures taxation in 1798, England turned to the net income tax in 1799 because of its greater equity, practicability, and revenue returns.

We have learned, however, that the personal income tax can be stretched only so far in war financing, when further increases must be confined to the income not required for investment in war bond purchases, in business enterprise, in debt payment, and in other channels of saving. With corporate taxation raised to new high levels and the personal income tax straining and groaning under the pressure for huge new revenues, it is daily becoming more apparent that future tax increases will logically develop in the direction of consumer imposts.

Bare subsistence incomes leave no surplus to be taken in taxation after the necessities of life are purchased. If these incomes are reduced by taxation they must be replenished by subsidies or other relief if health is not to be impaired. Modern nations therefore endeavor to confine their consumption taxes to nonessentials and to offset encroachments upon subsistence with allowances and other aid.

Our excises are popularly accepted as reasonably equitable taxes upon alcohol, tobacco, and other objects which are not absolute necessities, although they may conventionally be regarded as essentials. At any rate, the taxation of these articles presents no serious social problems arising from the impairment of necessary consumption and it produces handsome revenues. Some further increases in our excises may therefore be expected.

Determining Taxable Expenditures

Assuming wisely that revenues to supplement the collections from expanded personal income and excise taxes must be obtained if we are to hit at the roots of inflation and drain off surplus consumer funds and also to finance a greater part of the costs of the war by taxation, the Treasury has proposed a new spendings tax. Knowing that American families ordinarily do not keep account books which would show their expenditures in detail, the Treasury has follower earlier suggestions of Ogden L. Mills, Irving Fisher, and others to the extent of advocating that consumer expenditures be determined by subtracting various types of saving from the total funds of the taxpayer. It does not attempt to accomplish the complete breakdown of saving and spending, however, which Professor Fisher would endeavor to realize.

This is sensible because it is easier to calculate our nonbusiness expenditures by subtracting debt payments, life insurance premiums, taxes, and similar unexpended items from our

available funds than it is to obtain itemized records of our expenditures for food, clothing, housing, and many other articles. The taxpayers would be asked to report their available funds and their deductions in detail, however.

A better understanding of the Treasury spendings tax proposal will be gained and the process of determining taxable expenditures for the various recipients of funds will be illustrated if we note the individual spendings tax schedule which the Treasury suggested. Obviously, tax students will probably disagree over the definition of disposable funds and deductions, but the Treasury plan may serve at least as a basis of discussion. Any improvements and simplifications which could be introduced would redound to the advantage of the taxpayer and the government. The schedule is therefore submitted here as a problem which must be dealt with successfully if a spendings tax is to develop into a practicable, productive, and equitable impost. The perfection of the schedule should call forth the best talents of the tax administrator, the tax accountant, the tax lawyer, and the tax economist. No doubt the housewife, who distributes the family purse, can offer some common-sense suggestions.

The Individual Spendings Tax Schedule

(Treasury Proposal)

Funds at the disposal of the individual:

1. Salaries, wages, and other compensation for personal services. . $
2. Dividends and interest received, including government interest. .
3. Rents, royalties, annuities, pensions. . . . .
4. Withdrawals from business, professions, partnerships, trusts. . . .
5. Cash receipts from gifts, bequests, and insurance. . . . .
6. Receipts from sale of capital assets . . . .
7. Receipts from repayment of loans made to others. . . . .
8. Receipts from borrowing, including debts incurred in installment purchases. . . . .
9. Cash and bank balances at beginning of year. . . . .
10. Other receipts . . . .
11. Total disposable funds (Item 1 to 10) . . . .$

Deductions: Non-taxable use of funds:

12. Cash and bank balances at end of year. . . . .$
13. Cash gifts and contributions. . . .
14. Interest and taxes paid, except on owner-occupied homes. . . . . .
15. Expenditures on the purchase of capital assets . . . .
16. Life insurance premiums, annuity, and pension payments. .
17. Outlays for repayment of debt, including installment debt. . . .
18. Loans made to others. . . . .
19. Other non-taxable disbursements . . . .
20. Total deductions (Items 12 to 19) . . . .$
21. Expenditures subject to tax (Item 11 minus item 20) . . . . . .$

After each item in the disposable funds and deductions has been carefully studied and defined, with full consideration of the social and fiscal problems arising in each case, it will be necessary to determine the exemptions and the tax rates. The Treasury proposal allowed an exemption of $500 for a single person, $1,000 for a married couple, and $250 for each dependent. Workers and farmers may argue that these exemptions are too low; others will state that they allow for simple subsistence and the available supply of

consumer goods and services, which are becoming more scarce as the war continues. The principle to be recognized in the exemptions is clear; subsistence should be free from taxation. Controversy will arise, however, over the definition of subsistence, which will, in practice, be defined with reference to political and social, as well as financial, considerations.

The rates of the proposed Treasury spendings taxes were very drastic. The refundable tax was to carry a rate of 10 per cent and the surtax rates were graduated from 10 to 75 per cent, with higher exemptions. If one may judge from the reaction of the Senate Finance Committee, such terrific rates would not now be countenanced by Congress. The two taxes combined were to produce approximately $6 billion in new revenues. These revenues were incidental because the high tax rates were intended to prohibit inflationary spending rather than to swell the revenue stream.

What rates would be acceptable to the country if a spendings tax were initiated? Certainly the rates would have to be much lower than those advocated by the Treasury, perhaps ranging from about 5 to 25 or 30 per cent, unless public opinion should suddenly suffer a vast softening toward anti-inflationary taxes. A ceiling would be necessary, furthermore, in order to prevent the confiscation of income by the combined pressure of federal income, Victory, and spendings taxes in addition to state or local income taxes. In adopting a spendings tax of any weight it would be wise to drop the Victory tax as an additional charge and to convert it into a method of withholding spendings and income taxes at the source. Otherwise a great complexity of taxes would result.

Not a Sales Tax

A direct, graduated, personal spendings tax is plainly not a general sales tax, although, like a retail or other general sales tax, it is directed against consumer spending. Presumably the basis of a graduated spendings tax would be broader than that of a retail sales tax and would include expenditures upon personal services rendered by servants and other help about the house and elsewhere, as well as personal expenditures for such services as electricity, water, gas, oil, and telephone. A retail sales tax might, of course, be extended to include expenditures for items ordinarily excluded.

The essential difference between a graduated spendings and a retail tax is that the former is direct, personal, and graduated while the latter is indirect, impersonal, and not graduated beyond a possible tax rate of zero for certain exempt articles and a general flat rate for taxable commodities. That is, any graduation which creeps into a conventional retail sales tax is greatly limited. Basically, it is proportional in rate, and regressive in its effects. A graduated spendings tax would meet the inherent regression of the retail sales tax by applying graduated rates above the exempt expenditures. While a graduated spendings tax would not differentiate sharply between so-called necessary and luxury expenditures, it would tend to tax luxuries at higher rates because the tax rates would advance with expenditures. A retail sales tax, however, will tax the most luxurious expenditures at the same rate as the most necessary.

A graduated expenditures tax would be collected directly from consumers and would tend to remain with them. The same tendency would operate for a retail sales tax, but to the extent that it fell upon subsistence it would exert pressure for higher wages and prices. The graduated spendings tax would exempt subsistence and would offer less excuse or reason for wage and price disturbances than a retail sales tax without a similar exemption. Psychologically, a graduated spendings tax, if it could be enforced effectively, should prove more acceptable to the masses than a flat-rate sales tax, and it should produce less pressure for higher remuneration to meet the additional taxes.

On grounds of equity, a graduated spendings tax would be superior to a retail sales tax because it is far more personal and it may be adjusted to differences in expendable funds and responsibilities. It should produce as much or more revenue, depending upon the exemptions, deductions, tax rates, and success in administration.

Practicability of a Spendings Tax

The doubts over a direct, graduated spendings tax will arise from the uncertainty of its practicability, not over its equity and its potential revenue capacity. Would this untried tax be highly inconvenient and complicated, easily evaded, and costly of administration? Could such a tax be collected currently on daily spendings or would it, like the income tax, offer great difficulties to those who would streamline it into a completely modern war revenue which would be paid rather continuously?

After an investigation of the problems attendant upon the collection of a national retail sales tax and those which would arise from the administration of a graduated spendings tax, the spokesmen of the Treasury have argued that the latter would be less difficult to handle than a retail sales tax because the income tax collection agencies could be expanded without great difficulty to gather in spendings tax payments, while a new administrative unit would be required for a retail sales tax. This is, of course, a debatable proposition, especially in view of the lack of experience of our own and other governments in collecting a graduated spendings tax.

On the other hand, we have had considerable experience and success in the administration of the personal income tax and the willingness of the taxpayers to cooperate fully in the experiment of a spendings tax collected in conjunction with the income tax should assure it a reasonable chance of surviving the trying ordeals which await every new tax. The crux of the problems of administration and compliance will be found in the ease of determining taxable expenditures.

The objection that the personal income tax is already too complex and a new tax should not be added to it could be overcome by combining the normal and surtaxes into one schedule and dropping the earned income credit. The latter is unnecessary to lighten the tax load upon the small earned incomes because this may be done by applying lower tax rates to the smaller incomes, which are predominantly from wages and salaries.

Both the income and spendings tax should, so far as possible, be col-

lected currently at the source, both to raise quick revenues in draining off consumer funds and to render the payment of the heavy war taxes as convenient as possible. A percentage of gross incomes could be withheld at the source and this could be treated as a credit against the income and spendings taxes rather than an additional tax. Subsequent adjustments would be necessary at the end of the year to correct discrepancies between the taxes paid and the taxes due.

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CHAPTER 8

OTHER REVENUE SOURCES

JUST as there are many ways to "skin a cat," so there are many ways to fill the public treasury (and some would say, to skin the taxpayer). The previous chapters have by no means exhausted the finance minister's bag of tricks.

A time-honored device is to assess the population at so much per head—the poll tax. Some states make the payment of this tax a prerequisite for voting. It is this feature of poll taxation that has occasioned much current debate in and out of Congress.

Special taxes may be imposed on motorists either as license fees on automobiles or as levies on motor fuel. These taxes are usually supported on the ground that they assess highway users for their use of public highways. This implies that motor vehicle taxes will be used for highway construction and maintenance. However these taxes, over protest, are sometimes used to finance general government expenditures. In addition to a controversy over this so-called "diversion," there are the questions of whether trucks and busses are paying adequately for the commercial use of highways and whether the tax system, as a whole, is neutral among competing types of transportation.

Our social security system introduced the pay-roll tax. Both the propriety of this form of taxation and the provision of reserves to meet future social security obligations are the subjects of much recent argument. Some say that reserves are deflationary and others contend that they are only "sound insurance."

Extractive industries are frequently subject to special severance taxes justified in part on the ground that natural resources are a "national heritage." This brings us into the intriguing chapter in public finance called "The Single Tax," where we are confronted with the contention that land possesses unique economic characteristics which make it especially suited for taxation.

There are also revenue sources other than those commonly called taxes. The government may enter into real estate or other business, and may profit as landlord or entrepreneur. It may impose fines, fees,

and special assessments. The latter are ordinarily levied to recoup increments and other special benefits resulting from public improvements. The special assessment is often contrasted and compared with a land-value increment tax, which, however, applies to any increment, whether or not due to public improvement, and is collected at the time of a land transfer.

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The Poll Tax as a Condition for Voting

THE nonfiscal aspect of the poll tax has attracted much recent attention and was the subject of dispute in an interesting Congressional debate, a digest of which follows: *

Congress and the Poll Tax

Majority Report

The Senate Committee on the Judiciary

November 12, 1943, H.R. 7, outlawing the payment of a poll tax as a prerequisite to voting, was favorably reported to the Senate for action by the Senate Committee on the Judiciary. It was accompanied by a Minority Report. The following arguments were advanced by the majority in support of their action:

"House bill 7 makes unlawful the requirement of the payment of a poll tax as a prerequisite to voting in a general or other election for national officers. The principal question involved in this legislation is the constitutionality of the proposed legislation. The committee has reached the conclusion that the proposed legislation is constitutional and should be enacted into law.

"The qualification of a voter is believed to have something to do with the capacity of a voter. No State would have the constitutional authority to disqualify a voter otherwise qualified to vote, by setting up a pretended 'qualification' that in fact has nothing whatever to do with the real qualification of the voter. No one can claim that Sec. 2, Art. I of the Federal Constitution would give a legislature the right to say that no one should be entitled to vote unless, for instance, he had red hair, or had attained the age of 100 years, or any other artificial pretended qualification which, in fact, had nothing to do with capacity or real qualification.

* *Congressional Digest,* XXIII, Nos. 6–7 (June-July 1944), 180–183.

"The evil that the legislation seeks to correct is in effect that in taking advantage of the constitutional provision regarding qualifications, the States have no right to set up a perfectly arbitrary and meaningless pretended qualification which, in fact, is no qualification whatever and is only a pretended qualification by which large numbers of citizens are prohibited from voting simply because they are poor. Can it be said, in view of the civilization of the present day, that a man's poverty has anything to do with his qualification to vote? Can it be claimed that a man is incapacitated from voting simply because he is not able to pay the fee which is required of him when he goes to vote? In other words, when States have prevented citizens from voting simply because they are not able to pay the amount of money which is stipulated shall be paid, can such a course be said to have anything to do with the real qualifications of the voter? Is it not a plain attempt to take advantage of this provision of the Constitution and prevent citizens from voting by setting up a pretended qualification which, in fact, is no qualification at all?

"We believe there is no doubt but that the prerequisite of the payment of a poll tax in order to entitle a citizen to vote has nothing whatever to do with the qualifications of the voter, and that this method of disfranchising citizens is merely an artificial attempt to use the language of the Constitution, giving the State power to set up qualifications, by using other artificial means and methods which in fact have no relation whatever to qualifications.

"The subcommittee to which this proposed legislation was referred in the Seventy-seventh Congress held rather extended hearings and the full committee in this Congress has listened to very able and competent constitutional lawyers in the discussion of the constitutionality of the proposed legislation.

"The pretended poll-tax qualification for voting has no place in any modern system of government. We believe it is only a means, illegal and unconstitutional in its nature, that it is set up for the purpose of depriving thousands of citizens of the privilege of participating in governmental affairs by denying them a fundamental right—the right to vote.

"The requiring of a citizen to pay a poll tax before he can vote is in effect the requiring of the payment of money to exercise the highest 'qualification' of citizenship. It is in effect taxing a Federal function. The most sacred and highest of all Federal functions is the right to vote. It is not within the province of a State, or its legislature, to fix a fee or tax which a voter must pay in order to vote and try, in this way, to come within the Federal Constitution by calling this a qualification.

"Since voting is one of the fundamental governmental rights, the right to tax this fundamental privilege by a State would be giving to the State the power to destroy the Federal Government. No State can tax any Federal function. This is a proposition which will have to be admitted by all, and, if this Federal function—the right to vote—can be taxed by a State then the State has a right to destroy this Federal function which is, after all, the foundation of any government. As a matter of self-preservation, the Congress, in order to save the Federal Government from possible destruction, must

have the right to prevent any State authority from destroying this cornerstone of the Government itself.

"The right to vote for Members of Congress is a right, as the Supreme Court has said, granted under the Constitution of the United States and, therefore, any law, constitutional or statutory, of a State which taxes this fundamental privilege is contrary to the provisions of the Federal Constitution. It could be said, of course, if these poll-tax laws are unconstitutional, they could be taken to the Supreme Court and there challenged directly and that a law of Congress is therefore unnecessary to protect this constitutional right. This is undoubtedly correct but it does not follow that, when the Congress of the United States has had brought to its attention these poll-tax laws by which millions of our citizens are in effect deprived of their right to vote, that it would not be the duty of Congress itself to pass the necessary legislation to nullify such unconstitutional State laws. Most of these people are deprived of their right to vote by these poll-tax laws which are a method of taxation. As a rule they are poor people and are unable to vote because they are poor. The very fact that it is this class of people whose rights are being taken away makes it clear that they could not rely upon their constitutional rights of carrying their cases to the Supreme Court of the United States. The expense would be absolutely prohibitive and it is therefore the duty of Congress to protect these millions of citizens in their most sacred right as citizens—the right to vote.

"We think a careful examination of the so-called poll tax constitutional and statutory provisions, and an examination particularly of the constitutional conventions by which these amendments became a part of the State laws, will convince any disinterested person that the object of these State constitutional conventions, from which emanated mainly the poll-tax laws, were moved entirely and exclusively by a desire to exclude the Negro from voting. They attempted to do this in a constitutional way but, in order to follow such a course, they deemed it necessary to even prohibit the white voter the same as they did the colored voter and hence they devised the poll-tax method which applied to white and colored alike. In other words, the poll-tax laws were prohibitive to all people, regardless of color, who were poor and unable to pay the poll tax.

"It ought to be borne in mind also that many, if not all, of these constitutional amendments in the poll-tax States are in direct conflict with the statutes under which these States were readmitted to the Union.

"It seems perfectly plain that the object of the poll-tax provision in the State constitutions was not to prevent discrimination among the citizens but to definitely provide for a discrimination by which hundreds of thousands of citizens were taxed for the privilege of voting. It is likewise equally plain that at the end of the War between the States, when these States were readmitted to the Union, they were readmitted under a statute of Congress which provided explicitly that the constitutions of the States 'shall never be so amended or changed as to deprive any citizen or class of citizens of the United States of the right to vote.'

"It is therefore plain, under all the circumstances, that the so-called

poll-tax laws of the State bringing about such a disqualification to its citizens in the exercising of suffrage is in clear violation of the laws of Congress in addition to being a violation of the Constitution of the United States. It is a clear violation of the agreement made by the State, when it was readmitted, that it should not provide for such discriminatory amendments to the State constitutions. It follows therefore that the so-called poll-tax laws, bringing about the disfranchising of its citizens in the exercise of suffrage, are a clear violation of the laws of Congress in addition to being a violation of the Constitution of the United States.

"Those who believe the proposed legislation is unconstitutional rely on the statement of a historic fact that, when the Constitution was adopted, all of the original States had property or tax qualifications. This ignores entirely the testimony of scholars which clearly demonstrates why that fact alone does not prove the right of Congress today to forbid such requirements for voting in Federal elections.

"The most sacred right in our republican form of government is the right to vote. It is fundamental that that right should not be denied unless there are valid constitutional reasons therefor. It must be exercised freely by free men. If it is not, then we do not have a republican form of government. If we tax this fundamental right, we are taxing a Federal privilege.

"It is conceded, we think, even by those who believe the proposed law is unconstitutional that, while the poll tax is comparatively small in amount, if any poll tax at all can be enforced so as to prohibit voting by those who do not have the fee, the principle involved would permit the State to fix a fee much higher than is usually fixed now, and it is not at all unlikely that, in carrying out the real provisions of the poll-tax laws, this amount could be increased so that the poll tax might be fixed at $10, $50, $100, or even greater. The constitutional right to fix any poll-tax fee concedes the right to fix that fee at any amount desired.

"The sponsors of the poll-tax laws do not admit that they have prevented anyone from voting. In fact, these laws do not, on their face, directly prohibit any citizen from voting.

"The effect is brought about by the levying of a poll tax and providing that the citizen must pay this poll tax in order to vote. While he is not denied the right to vote, he is taxed for this privilege and, in case of poverty, this results in a denial of the privilege of voting and thus directly interferes with the citizen's right to participate in governmental affairs.

"It is quite clear that the so-called poll-tax laws do abridge the privileges and immunities of citizens of the United States. If any citizen of the United States is deprived of the privilege of voting by any of these poll-tax laws, it seems a clear abridgement of the privileges of citizens of the United States. One of the greatest privileges, and a fundamental one, of every citizen of the United States is the right to vote. If he is deprived of this right, he is denied the right to participate in governmental affairs. Such a citizen becomes an outcast. He is subject to all the laws of the State. His citizenship is admitted and the burdens which rest upon him are the same as rest upon

all other citizens. He can be drafted into the Army and be compelled to face the foe and give up his life to protect the lives of his fellow-citizens. Yet he is deprived of the most sacred privilege of all—the right to vote."

Minority Report

By U.S. Senator Tom Connally

Early in May [1944], the battle over H.R. 7, the bill to ban poll taxes as a prerequisite to voting, by an Act of Congress, began in the Senate. On May 9, the veteran Senator from Texas, Tom Connally, D., undertook to explain the South's opposition to the measure, stressing its unconstitutionality. The following paragraphs are taken from his speech to the Senate:

"The Senate of the United States is presented with a remarkable spectacle. We are involved in a globe-shaking war. The Congress and the administration are supposed to be devoting their efforts—and when I say 'their efforts' I mean all their efforts—toward the preparation for and prosecution of this war. In that effort nothing is more vital than unity and harmony and the morale of the 137,000,000 people who inhabit this Republic. It is proposed that the Senate halt in its efforts today in the prosecution of the war and, instead of hunting down our enemies, the Axis, instead of running down the followers of Hitler and hunting down Japanese enemies, it is proposed that we shall go out—not we but those who propose the bill—with a political net in an effort to ensnare a handful of votes.

"I believe that I speak the truth when I say that this is simply a political gesture, under the urgings of certain minority groups. I have no hesitation in naming them, if any Senator wishes me to name them. Under the lashing whips of threats that unless the Senate passes the bill, Senators who fail to vote for it will be punished at the polls, we are to be coerced into violating the most sacred traditions of this body. We are to be forced to repudiate the Constitution of the United States itself, which we are sworn when we enter this body to uphold.

"I deplore at this time dragging into this Chamber a measure calculated to arouse the passions—their prejudices are already aroused—of Senators, and from this central point to spread those prejudices and passions among the people of the United States at this crucial period.

"It is an absolute constitutional requirement, under the Federal Constitution, that every man who desires to vote for a Representative in Congress must possess the qualifications prescribed by the State in which he lives for those who vote for members of the most numerous branch of his legislature. That is an absolute compulsion of the Constitution. Yet, Mr. President, the pending bill proposes only, insofar as it affects voting for the President, Vice-President, Representatives, and Senators that the payment of the poll tax shall not be held to be a qualification. In other words, under this bill, if it should be enacted, we would have the situation of one voting requirement for Senators and Representatives, and another voting requirement for the members of the State legislatures. But can that be done under the Constitution? The Constitution says that the qualifications shall be the same.

"I do not disagree, of course, that, as the Constitution created Congress, it could have provided qualifications for Members of Congress different from the qualifications provided by the States. The framers of the Constitution, if they had so desired, could have set out in the Constitution itself the qualifications for voters for Representatives in Congress and for Senators. Certainly they could; and that is a very important point, because that exact point was brought forward in the Convention and the Convention voted against it. It voted down the proposal that the Constitution, the Federal Government itself, should fix the qualifications and, instead, set up the rule that the qualifications should be the same as those for electors of members of the State legislature.

"Every State has the unlimited and unquestioned power to decide the qualifications or the conditions or the restrictions or the limitations upon those who should vote in that State for public officers.

"Let us see what happened. Was that changed by the Constitution of the United States? No. I turn to amendment No. 10 of the Constitution. Senators should read that amendment at stated periods.

"So it is practically contemporaneous with the Constitution; it is practically a part of the original instrument. I quote:

" 'The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.'

"So those rights which the States possessed prior to the adoption of the Constitution still inhere in them unless the Constitution of the United States somewhere has prohibited or modified those powers. I challenge any Senator to show that Section 2 of Article I of the Constitution has ever been modified, or until the pending bill was presented, when any effort was ever made to modify it by statute or otherwise. So the power the States had originally still inheres in them.

"Personally, I have no attachment to the poll tax, as such. When it was submitted originally in my State, I voted against the levying of a poll tax.

"That is not the question before the Senate. The question is: Where is the authority to determine qualifications under the Constitution? That is what we are fighting for. We are fighting to maintain the integrity of the States under the Constitution. We are fighting to maintain the right and the freedom of the several commonwealths in the future to do just what many of the other States have done in the past.

"If the Congress has the power by statute to prescribe a qualification with respect to whether a voter shall pay a poll tax or shall not pay one, although the payment of a poll tax is required by State law, the Congress then has the power to prescribe any other qualification. If the Congress desired to do so, it could prescribe as a qualification that no one under 25 years of age should vote, notwithstanding the generally recognized rule that voters shall be 21 years of age. The Congress could require that no State should impose a literacy test as to voting. If the Congress should see fit to do so, it could abolish the registration systems in the States, or could provide that the States should have certain kinds of registration certificates.

"If the Congress can prescribe the

qualifications of voters in the several States, and if there is a great centralized government in Washington possessing the military authority and the power to enforce throughout the States the qualifications the Congress may set, it is conceivable that sooner or later there might be a government absolutely dictating at the point of the sword to the governments in the States and the centralized government itself in Washington.

"The people of the country can originate amendments to the Constitution. They do not have to wait until Congress submits a constitutional amendment. The Constitution provides methods by which the people themselves may initiate amendments to the Constitution. H.R. 7 is a bill. It ought to be entitled 'A bill to repeal Section 2 of Article I of the Constitution.' That would be speaking the truth. That would be frank. That would be candor. That would be courage. That would be plain common sense. That would be telling the truth. But now, what does it do? It does not do that. It tries to climb upon your back porch while you are sitting out on the front porch watching the cars go by.

"It is a palpable attempt by statute to say what certain provisions of the Constitution mean. If this Congress or any other Congress can, by legislative edict, say what a clause in the Constitution means or does not mean, then it can take over the Constitution entirely, and at any time we can say that the tenth amendment does not mean what it says, but we can say by statute it means something else. If we can construe the Constitution by an act of Congress, and determine that it means something contrary to its plain implication, then we can wipe out the Constitution by attacking one clause today, by attacking another clause tomorrow, or by striking down some other provision next week or next month, and thereby absolutely strike down the Constitution and the things it guarantees.

"I wish to say that this is not a colored and white fight at all. In my State the regulation applies to white persons as well as colored. Many white people are indifferent to voting. Senators have talked about great sections of people being prevented from voting because they did not pay a poll tax. I ask them to consider their own States, and they will observe from the election returns, as compared with the census returns, that only a percentage of the voters, after all, vote in some of the States. Why? Because of indifference; because voters are absent from home, or are engaged in doing something else. Some voters stay at home and take no interest in politics. I have heard persons brag, 'I don't take any interest in politics,' and they thought it was something to be applauded. They thought they were high and mighty. They would say, 'I do not approve of politics.' Of course, that kind of a citizen has no place in America, and should not be allowed to enjoy its blessings and benefits without asserting and exercising his responsibilities as a citizen.

"Of course, no one is attacking the constitutional provision guaranteeing a republican form of government. If it is said that some person is not permitted to vote because he does not pay a poll tax, and therefore that is not free government and not a republican form of government, I wish to say that we have to go back to the old Constitutional Convention again. The same men

who wrote the provision that every State should be guaranteed a republican form of government also wrote the requirement as to voting. They knew that Virginia had a law requiring a voter to hold so much land or pay so much taxes. They knew that Pennsylvania had a law which required the payment of taxes. They knew that Massachusetts, New Hampshire, Vermont, and other States had similar laws. They did not regard the existence of those laws as the denial of a republican form of government.

"There is nowhere any inherent constitutional right of a person to vote. Suffrage is a creature of the law of the sovereignty where it is exercised. So far as I know, that principle has never been questioned in any respectable forum.

"This matter is one of the most serious import. If we are to lay down the doctrine that constitutional provisions can be modified or construed —and there is no difference between modifying a thing and construing it if it is construed in the way in which we wish to modify it—if the Congress can construe or modify the Constitution of the United States by violating its plain provisions, and can undertake to regulate suffrage by denying the right of a State to levy a poll tax or impose any similar provision, then Congress has the power to prescribe any other qualification it may see fit to prescribe. It not only has the right of prohibition or denial, requiring that voters shall possess certain qualifications, but it has the affirmative power to require the States to impose certain conditions or requirements with respect to suffrage within the States. In effect, it would amount to a delivery by the States to the Federal Government of the control of suffrage, the very root, the very foundation, the very subsoil of liberty and free government itself. Suffrage ought to be left within the control of the people of the sovereignty which is affected."

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THOMAS P. HENRY

The Motor-Vehicle-Tax Problem

ONE of the principal functions of governments is to facilitate transportation. In the United States in recent years this has taken the form mainly of providing highly improved roads for automobiles, busses, and trucks. Collateral to the outlay for this purpose there has developed a system of motor-vehicle taxes. These taxes were "sold" largely on the ground that those who use the highways should pay for them. Proponents of higher motor-vehicle taxes argue that total highway outlays are still greater than highway taxes and that even if this were not true,

excises on motor vehicles and motor fuel could be justified as "luxury" taxes. These arguments are rebutted by those interested in the development of highway and motor vehicles. Particularly resented is the use of motor-vehicle-tax revenues for other than highway purposes—called "diversion." Two views of this issue are presented here. The first is part of an article written in 1939 by Thomas P. Henry, of the American Automobile Association, stating the motorist's case; * it is followed by a graphic presentation of the trend in gasoline taxes and prices prepared by the American Petroleum Industries Committee.

Taxes against motorists are high and going higher. Not only are the old, customary taxes costing more but new ones are being added, the most annoying of these being evidenced by the sudden eruption of toll gates on public highways. A smoldering quarrel has been under way for years on the way automotive tax money, now at an all-time peak of $1,500,000,000, should be spent. Diversion—the switching of such taxes to other than highway issues—is a fighting matter in many states and will soon be so in many more.

There are so many angles in this complex public problem that the case for justice to motordom is presented as a series of talks by a well-informed motorist to various acquaintances met en route. One of them might be you.

To a Motorcycle Cop in State A

You say I've been driving dangerously. Well, brother, it's pretty hard not to do that on these narrow, curving roads of yours. It's a shame to have such highways in a rich state like this. Wouldn't be necessary, either, if your legislature would spend honestly on highways all the money it collects from motorists.

Do you know how much automotive tax money—money paid by motorists for highway purposes—was diverted to other causes last year right here in this state? Well, I'll tell you: $10,000,000. Altogether your politicians have diverted a hundred millions or so since 1925. Now if you folks had spent those sums on your roads, you wouldn't have to get after us visitors quite so fast.

What's that? You're not interested. You'd better be! You're talking to one of your paymasters. Of course, I'm just an average motorist, one of over 25,000,000 in these United States, but all of us chip in for the salaries, equipment and administrative expenses of your department. Yes, sir, in 1938 we motorists paid nearly $23,500,000 for the patrolling of American highways. You are doing a fine job and we need more of you, but do not forget that if it weren't for us you wouldn't have a job or pay check. We're the best-hearted taxpayers in the world and the decentest lot of travelers. Give us better roads and we'll cause you less trouble and have fewer accidents.

I suppose legislators who vote to divert automotive tax money never reflect that they may be partly responsible for highway accidents. Yet

* Reprinted by permission from "Mr. Motorist Speaks Out," *Current History*, October, 1939, pp. 53–57.

their votes perpetuate conditions hazardous to every motorist. Public officials often salve their consciences by plastering the roadways with signs—"Danger—Narrow Bridge"; "Danger—Sharp Curves." My point is that if all automotive taxes were spent on highway improvements there wouldn't be as many narrow bridges, sharp curves—or automobile wrecks. New York, diverting $40,000,000 to $75,000,000 a year, is a gross offender on narrow bridges; yet there needn't be a single dangerously narrow bridge in the whole State if New York had observed the principle of road taxes for roads only.

All the great diverting States have their special highway hazards and inconveniences. Ohio, diverting $12,000,000 for schools, is a maze of railway grade crossings. Florida lets its cattle and hogs roam the highways unmolested. Pennsylvania excels in narrow, curving main highways where traffic rolls slowly up and down hill, long files of cars being unable to pass a sluggish leader. And Texas of the wide open spaces, where snake-roads wind through the plains, has more than 200,000 miles of unsurfaced highways. Don't tell me there isn't need in highway work for every dollar these States divert!

* * * *

To the Tax-Conscious Business Man —Anywhere

As a business man, you're more interested in taxes today than ever before. There are good reasons why you should be particularly interested in automotive taxes, as I think these facts and figures I'm about to recite will speedily make you see.

When automobiles were few, they were the possessions of the rich and consequently hated by the masses. Therefore they were highly taxed, not merely as personal property, but also as dangerous vehicles. The public roads, moreover, were subject to heavy damage because of tire suction on their soft surfaces. The system of high license fees then inaugurated to cover a few cars continues to apply in general to our present gigantic complement of thirty million automobiles in the hands of the masses. This license system raises the enormous revenue of $400,000,000 a year. That whopping sum represents one-eighth of the combined budgets of all the forty-eight states.

At the very outset of its tax-ridden life, the automobile is taxed as a new piece of wealth, a manufactured unit. This is done through a federal sales tax, officially known as a manufacturers' excise levy but actually a sales tax; no new car or part can pass into a customer's hands before it is paid. Initiated as a war measure in 1917, this tax has been levied ever since except for the three years 1929, 1930 and 1931—a neat example of the tendency of an emergency tax to become permanent after the emergency passes. As a business man, you probably know that tendency all too well. No one has given a convincing reason for federal taxing of the manufacture and sale of automobiles and parts and immunity for such kindred items as locomotives and tractors. All automobile manufacturers resent this discrimination; some of them even think the levy hurts sales. But it is a consistent revenue producer, bringing into the United States Treasury about $50,000,000 a year.

Now let's look at a third automotive tax. In 1919, after twenty years of hit-or-miss taxation, an organiza-

tion of motorists in Oregon petitioned the State legislature to tax gasoline one cent a gallon and apply the proceeds to highway construction and maintenance. The legislature did so with the understanding that this tax was intended to be a charge based on measure of highway use; by paying it car owners would greatly increase the utility of their vehicles. Under this understanding, always implied and frequently expressed in solemn legal language, other states followed Oregon's lead.

Today there is no consistency in gasoline taxes. In 1925, 2 cents a gallon was the standard tax, with more than half the states using that rate; but in 1938 only Missouri and the District of Columbia were satisfied with 2 cents, although it should be stated that the over-all tax in Missouri reached high proportions because of the incidence of local taxes. From 1929 on, the most popular rate with the states has been 4 cents, while the weighted average for the nation is now 3.96 cents.

* * * *

Some states still permit cities and counties to tax gasoline. In Missouri these local levies may lift the tax 1½ cents, and in Alabama 6 cents. In certain Alabama cities the highest gasoline tax in the Union is reached at 12 cents; but for a whole State, Mississippi levies the highest tax—9 cents, 6 cents for the State, 3 for the counties. Since 1 cent has to be added for the federal tax, the standard motor fuel of the nation bears from 3 cents to 13 cents tax per gallon, and on that basis raises about $770,000,000 net for the states and $200,000,000 for the federal government each year, at the remarkably low expense of $4,000,000 to the states for collection and administration and a proportionately low sum to the federal government.

Not content with taxing automobiles at point of original sale, the federal government began in 1938 to tax gasoline a cent a gallon and to levy excise taxes on motor oil, tires, and parts. All federal taxes on cars, fuels and parts have averaged $300,000,000 a year for the past four years.

* * * *

Yet at nearly every point in the automotive tax structure, the revenue hunters are ready to spring more tax-traps. Consider the taxes now being collected at toll gates to be found on many of our highways—most of them, it is true, ferries and bridges. The number of toll gates runs into the hundreds in authoritative tourist guides.

At the moment there is serious danger that the search for exploitation of the motorist may take the brand new turn of putting tolls on highways which were formerly free and paid for. Some time ago the State of Connecticut imposed a 10-cent toll on its new Merritt Parkway. The official reason given was that revenue was necessary for extension of the highway. Thereupon, New York's Westchester County countered with a 10-cent toll on its Hutchinson River Parkway. As there already was a 10-cent toll bridge on this popular route to New York City, motorists now pay 30 cents in tolls within thirty miles. Other tolls are threatened on other links in the route. With the World's Fair pulling tourists through that toll-ridden corner of the country, motorists from all parts of the nation are getting a close-up view of this situation.

Thus, motorists have another tax added to those already in existence. Thus the toll gates spread again over

a land that forty years ago fought for their removal and more recently rejoiced in the victory of freedom of the roads.

That this is no isolated instance may be seen by glancing at the American Automobile Association's Directory of Bridges, Ferries and Steamship Lines, which locates more than two hundred toll bridges, average charge 50 cents each. Twenty-two toll roads are listed, average charge $1.50. But the list was compiled last winter and so does not contain the lush crop of tolls added during the summer of 1939.

The United States, the greatest of all free-trade areas, is being cut up by discriminatory taxes and state border controls, and even counties are now beginning to charge tolls on their highway facilities. Let this reactionary trend continue, Mr. Business Man, and it will bring stagnation to business and social life in this country.

Controversy in the field has sharpened substantially as the degree of the gasoline tax has responded both to the need for revenue and to the development of the highway system. Objection has been strengthened considerably by the appearance of well-organized interest groups. These include organizations of road users, of cement manufacturers, and of petroleum refiners and distributors. One such interest group has prepared the following graphic presentation of the rise in motor fuel taxes in the prewar period. The chart also shows that while the incidence of motor fuel taxes is borne largely by consumers of gasoline, they have nevertheless enjoyed reduced prices due to economies in production.

In interpreting these figures one should remember that:

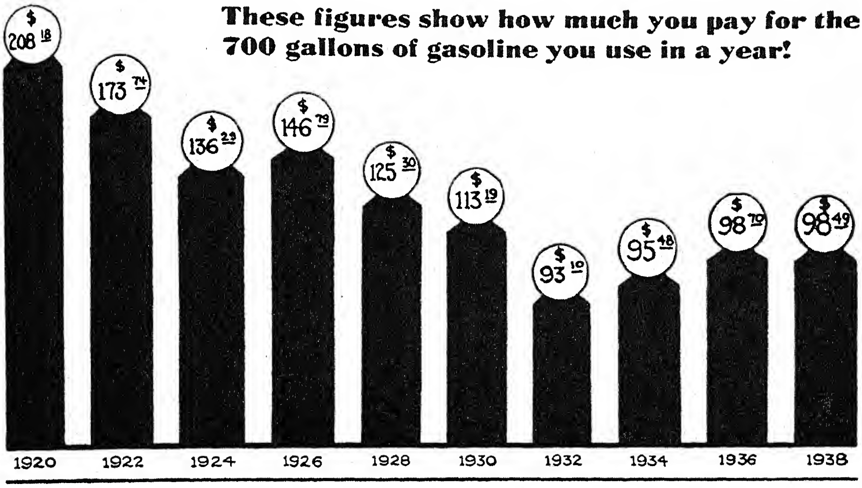
1. the gasoline tax is uniquely a special benefit tax and that it naturally expands with outlays for highways;

2. improved highways probably save the motorist a cent or two per mile in the operation of his automobile;

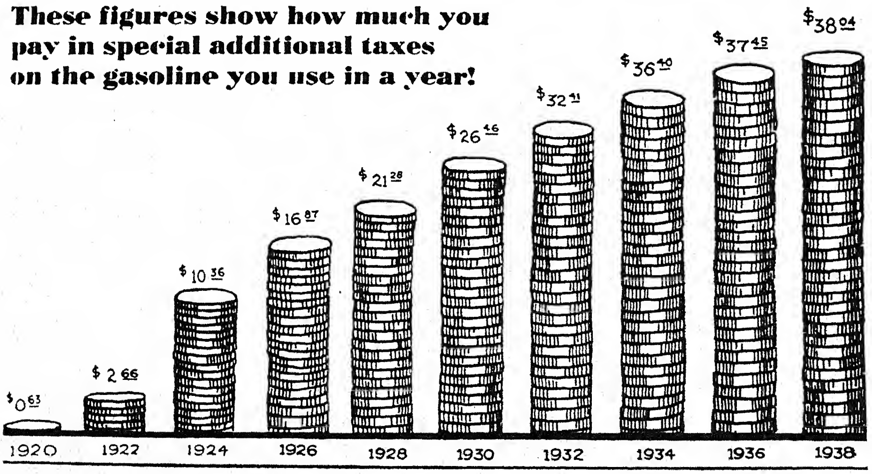
3. the tax is also used substantially as a special excise—like the tax on cigarettes. To the proponents of such use the consumption of gasoline is as logical a tax base as many others employed by governments since ancient times. Moreover, the supply of gasoline is limited and a tax may help to conserve the resources remaining.

Gasoline Is Cheap! Only the Tax Is High!

These figures show how much you pay for the 700 gallons of gasoline you use in a year!



These figures show how much you pay in special additional taxes on the gasoline you use in a year!



GOVERNOR WALTER S. GOODLAND

Message Vetoing a Bill to Segregate Highway Tax Revenues in Wisconsin

IN MANY states opponents of motor vehicle tax "diversion" have sought to pass legislation requiring that revenue from motor vehicle taxes be used exclusively for highway purposes. The Wisconsin legislature in 1941 passed such legislation. The bill was vetoed by Governor Goodland but was passed over his veto. The veto message reproduced below states the Governor's objections to the bill.*

United States of America—The State of Wisconsin—Executive Department:

To the Honorable, the Assembly:

I return herewith Bill No. 158, A., without my approval.

At the outset I wish to state that I have always favored, and now favor, a good highway program for Wisconsin. My record as a legislator and as Governor is convincing proof of that statement. Wisconsin has been one of the leading states in the Union in highway development. I have always advocated, and now advocate, legislation that will enable Wisconsin to maintain that leadership. However, I have never favored, and do not now favor, any major program of state activity to the detriment, sacrifice or jeopardy of other equally important major services of the state government.

I realize full well the propulsion developed behind this bill which carried it through both houses of the legislature,—a force so strong and seemingly convincing that it passed the house of origin without a dissenting vote, under suspension of the rules, and without much discussion or analysis. The power behind the bill was a combination of forces which may be described in two main classifications: (1) well-meaning citizens, taxpayers' groups and representatives of county and local units of government, many of whom have been lulled into a false sense of security by the magic promises and purposes of segregation with expectation of assured and immediate full measure of highway benefits; and (2) special interest pressure groups consisting of individuals and representatives of firms and corporations whose business is highway construction or is directly concerned with or related to highway construction and improvement.

It is my belief that this veto will be highly unpopular with the special interest groups referred to in the second classification. It is also my belief and hope that the facts and reasons included in this message will be con-

* Message to Assembly on Bill 158, A., Madison, Wisconsin, May 31, 1945.

sidered and weighed impartially by those citizens who may have been temporarily won by the segregation appeal and who may not have had the opportunity of studying or the means of knowing the implications of the segregation proposal in Bill No. 158, A.

Our state fiscal system is a complex affair, delicately balanced and attuned to the needs of all of the people, the state government and local units of government. An attempt such as proposed in this bill to alter the existing system to favor one state activity, highway construction, without taking into account the rest of the state government's activities and services, which are no less important, transmits down the line a series of reverberations that inevitably will produce serious difficulties in the future.

As chief executive of this state, sworn to serve the best interests of the whole state, irrespective of the selfish desires of special interest groups, and in the face of a synthetic popular appeal for the purposes of this bill, I am compelled to veto this measure because it is against sound public policy.

Bill No. 158, A., would segregate in a special state highway trust fund all taxes collected as motor vehicle registration and license fees, operators' license fees, motor carrier fees and taxes, and motor vehicle fuel taxes. According to estimates of responsible state fiscal authorities, this would syphon out of the general fund revenues of the state totalling more than $36,000,000 annually, or more than one-fourth of the total revenues collected by the state for operating and maintaining the government.

The principal reason advanced by proponents of this program of segregation is that only by such means will an adequate highway construction program for the state be assured; that only by such program can the receipt of federal highway aid be insured to the state and local units of government. These same proponents also argue that the highway system of Wisconsin has been starved and neglected.

I deny the accuracy of these assertions. First, let me point to the fact that figures of the Bureau of the Budget show that during the eleven-year period from 1933 to 1944, a total of $107,129,000 was provided and spent for highway construction alone. During the same eleven-year period, the major state institutions received a total of $2,321,000 for buildings and other improvements.

The 1945 State Budget, including the state trunk highway trust fund established in 1943, provides a comprehensive and large current and postwar policy highway construction and maintenance program without segregation of all so-called highway monies. Specifically, the provisions for 1945–1947 are:

For construction of roads (Includes $4,500,000 in federal aid)	$10,350,000
For maintenance	13,000,000
For snow removal	3,000,000
For aids to counties and localities	29,258,750
For administration, engineering, surveys, supervision, etc.	2,961,200
For Motor Vehicle Department, Planning Board and Department of Taxation	2,157,626
	$60,727,576

For transfer to Highway Trust Fund ...	13,000,000
	$73,727,576
Recommended in Bill No. 174, A., for construction of roads ..	5,000,000
Total contemplated charges against the general fund for Highway purposes during the biennium 1945–1947 under existing laws. (Includes $4,500,000 in federal aid)	$78,727,576

After making the above charges there will be an estimated balance of $4,930,169.86 in the appropriation accounts of the state highway commission available, if needed with the approval of my office.

Construction funds provided in the general fund and the present state trunk highway trust fund for current and postwar road construction may be summarized as follows:

General Fund charges proposed in the 1945 state budget for new roads construction during 1945–1947 ..		$10,350,000
Bill No. 174, A., for construction of Roads		5,000,000
Transfers to State Trunk Highway Construction Fund:		
1942–43	$7,436,336	
1943–44	4,780,168	
1944–45	5,471,754	
1945–46	6,250,000	
1946–47	6,750,000	30,688,258
Interest on State Trunk Highway Fund securities		351,312
		$46,389,570
Total Budgeted Funds available for Highway Construction. (Includes only $4,500,000 in Federal aid.) Total federal aid allotment pursuant to the "Federal Aid Highway Act of 1944" is $11,770,486 or $7,270,486 in addition to the $4,500,000 budgeted		7,270,486
Total Funds available for Highway Construction to 6/30/47		$53,660,056

This amount does *not* include the transfer to the state trunk highway trust fund on July 1, 1947 of $7,166,426, available from highway revenues provided in 1946–1947 of my administration. I consider this amount the expenditure concern of the 1947 legislature and have not included it in the highway construction funds provided during my term in office.

I have itemized these figures to point out to you that highway needs are adequately and generously provided for under existing laws. Segregation of highway monies is decidedly not necessary from the standpoint of a substantial highway program, and certainly not from the standpoint of good fiscal policy.

In view of other highly urgent needs of this state, it seems to me that these sums make liberal provision for highway purposes. I have always been, and am today interested in an adequate highway program for the state of Wisconsin. Highways are an important state service and it has been my purpose to protect those communities and districts in need of better highways. That is why

I approved a bill two years ago setting aside the unexpended balance of county highway allotments at the end of each fiscal year to the credit of the counties for the exclusive purpose of insuring retirement of county bonds and the future construction of state trunk highways in each county. By that action they were and are assured of their just share of highway money.

Is it possible that those who are so intensely interested in highways have become emboldened by their successes and can see no other purpose for state government than to make funds available for highway purposes? They seem to have overlooked the important fact that highways are only one of a number of important state services required by the citizens of Wisconsin and which are financed from funds in the general fund. They do not recognize the serious dangers to which they are exposing the whole operation of state government.

There are those who urge the segregation of highway funds at this time on the ground that this bill belatedly corrects legislative intent of years ago when legislation was passed using the phrase "highway funds." In 1941 an attempt was made to enjoin the secretary of state and the state treasurer from expending motor vehicle registration and operators' fees and gasoline fuel tax receipts for any purpose other than highway construction and maintenance.

In Friedrick *v.* Zimmerman, 238 Wis. 148, decided in 1941, the Wisconsin Supreme Court denied that such revenues are to be considered as sacred and a special trust fund. The court declared such revenues to be part of the general fund and pointed out that had the Legislature intended that the revenues received from the sources mentioned should constitute a trust fund, it would have so provided.

Efforts have been made by past Legislatures to segregate these revenues into a separate highway trust fund. In the four preceding sessions a total of ten bills were introduced providing that such revenues be used exclusively for highway purposes. In the sessions from 1935 to 1943 a total of nine constitutional amendments were offered prohibiting the use of such revenues for other than highway purposes. All of these proposals failed because it was realized that such a step was bad policy and fiscally unsound. Conditions today and in the foreseeable future make such proposals today even more unsound.

In a recent letter to the citizens of Wisconsin discussing my entire financial plan for the state, I said that segregation might find us practically bankrupt for the necessary expenses of government while at the same time there would be huge sums of money in the treasury that, under the law, could not be touched for anything but highways.

As I see the situation, the proposal of segregation of state revenues for specific purposes is fundamentally unsound. It singles out and separates a particular type of tax dollar and glorifies it with a sacred halo. The proposal is especially dangerous to even consider at this time. I am certainly not inclined toward pessimism but it is true, I believe, that we face in the reconversion period and the postwar economy just ahead an uncertain future. To pile up and manufacture more uncertainties now, at the very time when we have the magnificent opportunity of preparing sensibly for the future, is illogical, unwise and unbusinesslike.

Segregation as proposed in this bill is contrary to sound principles of government. Any segregation which sets aside taxes in a special fund to be used only for a special purpose as a matter of permanent policy is exceedingly dangerous. History of segregation in other states has proved that from a standpoint of good, sound financing it has hindered the general activities of such states immeasurably.

A segregated tax once set up becomes an "untouchable" and continues to hold its favored position regardless of major difficulties confronting the lawmakers in financing general activities. The tendency of modern governmental finance is one of eliminating special funds rather than creating new ones. These views are shared by the governors of Minnesota and New Jersey, one of whom stated in a recent letter to me:

"It is generally agreed by governmental experts and students of state government that dedicated funds are not the soundest nor the most advisable as has been proven during this war era."

I am also informed that the state of New Jersey recently repealed its law providing for segregation of highway funds.

In my message to the Legislature I presented in outline, and later in the specific form of budget and revenue bills, a carefully worked out plan for state finances and institutional improvement. Highways were given their proportionate share. The overall state problems were carefully considered and given due attention.

It must also be pointed out that Bill No. 158, A., as passed by the Legislature, proposes to deprive the general fund of the revenues accruing from motor transportation taxes and fees of approximately $4,000,000 for the biennium in normal times. This revenue has heretofore been used to finance the executive budget. No provision is made to replace this lost income.

Complete highway segregation can lead to only one thing—new taxes. I have stated time and again that on the basis of estimates of income provided me by the department of taxation and careful examination of budget requests from the various departments of the state incorporated in the executive budget, new or additional taxes are not necessary. An extensive highway program can be provided for and the building program carried out as proposed without the imposition of additional taxation.

We must, however, face the fact that if we are to provide the urgently needed construction and improvement program for our state institutions, which I am confident the citizens of this state approve and demand, and if the segregation of highway funds is accomplished, as proposed in this bill, an additional tax burden must necessarily be imposed on the people of this state in order to meet the costs involved.

The additional taxation which would necessarily follow the segregating of highway taxes, in my opinion, does not represent the wishes of the taxpayer. I cannot believe that the average citizen desires that gas tax, motor license fees and other highway revenues be set aside to promote an uninterrupted highway program at the expense of the taxpayer if it means additional taxes to him. It is true that highway monies were used for general purposes during the depression years, which in those years eliminated the need for higher taxes

to finance general government.

I am confident that very few people in the state of Wisconsin realize the full significance of highway segregation. It is true we have a sizeable surplus at present, and it is true that highway segregation, in view of such a surplus, seems to some people reasonable and just. However, past history shows that segregation eventually will lead to additional taxes in the lean years.

Although some of the people in this state may think that they desire highway segregation, I am certain that if they had a clear understanding of the purposes and meaning of this bill and realized the full implication of segregation, namely, the imposition of additional taxes in the immediate or near future, they would oppose the legislation here proposed. No one man, no group of men, can precisely forecast our future. Financial preparedness is the staunch and ready bulwark against uncertainty—whether in the home, in business or in government. Let us, therefore, make sure that what we do now does not add to that uncertainty. That is an obligation I owe, and the Legislature owes, to the people of Wisconsin. For this reason and those enumerated above, I am compelled to withhold my approval.

Respectfully submitted,

WALTER S. GOODLAND,
Governor.

May 31, 1945.

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RONALD B. WELCH

The Property-Tax Equivalent on Highway Investments *

A MAJOR problem in the taxation of carriers is that of neutral treatment for competing forms of transportation. The author of the following two selections served as chief of staff in an extensive investigation of this field at the behest of Congress.

The major reason why motor carriers pay small property taxes relative to their total taxes is not the exemption of vehicles or the infrequency of assessment at going-concern values; it is the fact that the right-of-way and roadbed are public rather than private property. Publicly owned property is not taxed, and the question therefore arises whether the use of this tax-free property gives to the motor carriers a competitive

* *Carrier Taxation,* pp. 184–186.

advantage over the rail carriers, who own and are almost universally taxed upon their roadways.

New investments in privately owned property are made only when there are reasonable prospects of securing a return large enough to cover maintenance costs, amortization of the investment, interest on the investment, and property taxes. If public funds are invested in business properties with lesser expectations, there is at least a presumption that the funds used for this purpose would have been more productively invested if allowed to remain in the hands of the taxpayers or government bond buyers. In transportation terms, this means that highways, waterways, and airways, unless they yield a "property-tax equivalent," tend to be overdeveloped relative to railroads and pipe lines, and that the transportation system as a whole tends to contribute less to the national income than might be contributed with an equal amount of capital and labor and a different investment pattern.

The problem is by no means as simple as this when the publicly owned property is not regarded simply as a business investment. For example, the government may feel justified in providing highway facilities for recreational purposes comparable to those served by public parks. Again, it may believe that the highways serve a useful purpose in knitting together the social fabric. The value which government ascribes to the service of these and other purposes may be counted as a return on the public investment along with the monetary returns exacted from highway users.

The use of highways as work-relief projects and as outlets for public investments under the "new philosophy" of the public debt also immensely complicates the problem of a property-tax equivalent. It is better that government absorb idle funds by taxes and deficit financing and expend them on projects incapable of yielding as large a return as is demanded by private investors than that capital and labor resources be unused in a period of economic stagnation, just as it is better that we should have an unbalanced transportation system than none at all.

But enthusiasm for recently popularized government fiscal policies should not obscure the facts that publicly invested funds must in the long run be taken from the citizens largely in the form of taxes, that at least some of these funds would have been privately invested if left in private hands, and that the private investments would presumably not only have yielded returns to their owners but would also have yielded property taxes to the government. Certainly on many public investments in transportation facilities, government should expect to recover from the transportation agencies a property-tax equivalent, so that it may, in effect, pay itself, or may actually pay to other governments, a property tax on the investment. The charges made to those who patronize these facilities should be high enough to yield this property-tax equivalent; how high would depend upon property-tax institutions and the prudence with which public funds were invested.[1]

[1] Recognition of this principle was accorded by the United States District Court, Southern District of Illinois, in its opinion in *Brashear Freight Lines, Inc.* v. *Hughes* (1938) 26 Fed. Supp. 908, when it acknowledged as a proper element of highway cost "a charge on the unamortized portion of

It is impossible to compute the property-tax equivalent on past public investments with any degree of precision, but something may be said of its general magnitude. The unamortized investment in the public highways and streets at the beginning of 1940 has been estimated at $16,141,879,000.[2] If this investment had produced equivalent market values and had been taxed at the average rate applicable to the full market value of private property, it would have yielded property taxes of somewhere near $300,000,000. However, a considerable part of the investment in highways was intended to benefit landowners rather than highway users or is allocable to governments in their highway-user capacities. If private highway users are held responsible for that percentage of the unamortized investment in highways that their responsibility for 1940 highway costs (including interest costs) bore to total 1940 highway costs (including interest costs),[3] the investment assigned to them is only $8,372,357,000. Property with a market value of this amount would yield, in private ownership, taxes of perhaps $150,000,000.

It is to be doubted, however, that public funds have been so carefully invested in highways as to produce a dollar of market value for each dollar of investment. If highway investments have been made with no thought that they will yield a property-tax equivalent, their market value to a private owner who would be subject to property taxation is probably well below the amount of money invested in them. It is also evident that there have been imprudent investments in highways as there have been in railroads, not all of which have been offset by depreciation of the original investments. How far the highway investment should be discounted for these two factors it is impossible to say, but a 40-percent discount does not seem extravagant. This would bring the property-tax equivalent assignable to highway users down to $90,000,000 for the year 1940.[4]

It will be observed that this figure makes no allowance for the possibility that rights-of-way may have a market value exceeding the investment made in them. In view of the fact that these rights-of-way were in large measure dedicated to the public without charge, and were for the most part acquired when land values were low even when purchased or condemned, this may appear to be a serious omission. But the omission is advertent. When the government acquires a right-of-way for highway purposes, there is a diversion of capital from taxed to untaxed invest-

such investment representing taxes foregone by the State and its political subdivisions through the investment of such funds in public facilities in lieu of taxable property * * * " Elsewhere (e.g., Federal Coordinator of Transportation, Public Aids to Transportation, vol. 4, p. 52) a curious confusion is evidenced by the argument that collection of a property-tax equivalent on highways which have been constructed out of the proceeds of user taxes would be inequitable. The fact that the railroads have provided the funds used for the construction of their ways has never been urged as a reason for exempting them from property taxes.

[2] See Board of Investigation and Research, *Public Aids to Domestic Transportation*, Chap. 4.

[3] This percentage, as developed in the Board's report on public aids, is 51.87+.

[4] The research staff of the Federal Coordinator of Transportation, using a somewhat different set of assumptions, arrived at a 1932 figure of $76,507,000. (See *Public Aids to Transportation*, vol. IV, pp. 52, 75.)

ments only to the extent that the land occupied as a right-of-way had value for alternative purposes. Usually such value was small and was more than compensated by the increase in taxable values of adjacent lands.

It is argued by those who favor a large property-tax equivalent that the railroads, too, enhance the value of adjacent lands and are still taxed upon the full value of their rights-of-way. But the full value of a railroad right-of-way cannot be measured by appraising the adjoining land, and few assessors value it in this manner.[5] In general, the value of a railroad right-of-way is determined by its contribution to the earning power of the railroad. Regulatory agencies have seen to it that this contribution does not appreciably exceed the actual investment in the right-of-way. When the railroad cannot earn a fair return on the investment, the right-of-way presumably contributes to the road's market value in an amount that falls short of the investment in it. The rail carriers cannot ask on the one hand that their property-tax assessment be measured by the earning power of their property and on the other that the motor carriers pay a property-tax equivalent upon the public investment in highways plus an excess of right-of-way value over cost computed by reference to the value of adjoining lands.

If governments were to collect from highway users a property-tax equivalent, this equivalent would not appear as a property tax in the accounts of the motor carriers, but rather in the form of tolls, gasoline taxes, or other charges closely related to highway usage. Whether or not such an equivalent is collected can only be determined by examining the highway-user charges and comparing them with highway costs. For such a comparison, the reader is referred to the Board's report on public aids to transportation. The adequacy of any such component of the highway-user charges must be examined in the light of general tax payments and obligations to support the nonhighway functions of government.

[5] However, to the extent that assessors rely upon engineering appraisals of railroad property, their assessments are influenced by the value of lands adjoining rights-of-way.

RONALD B. WELCH

Measuring Comparative Tax Burdens of Carriers *

War is said to produce certain casualties in which some part of a soldier's anatomy is paralyzed and the doctors find it difficult to tell whether the victim is suffering a physical injury or merely thinks that he is. Overtaxation has something in common with this type of casualty. The victim is certain that he is injured; the disinterested layman is easily convinced that the injury is a real one; and only the experts are in doubt. If this is the earmark of an expert on overtaxation, I am one of the leading experts in the field! For despite nearly two years of continuous study of carrier taxation, I am still unable to pronounce the last word in the long-standing argument on the relative tax burdens of the railroads and their principal competitors.

The important question, of course, is not whether overtaxation has existed; nor is it so much a question whether it now exists, for the exigencies of war finance do not yield readily to principles of equity. It is essentially a question of what will exist in the post-war period. What has been for the most part a rail-highway controversy in the past twenty years will probably soon become at least a triangular affair involving the airlines, and the rapid expansion of shipping and pipe-line facilities during the war may conceivably focus considerable attention on these heretofore largely neglected groups of carrier taxpayers.

But it is not for lack of soothsaying powers that I address the problem of carrier taxation with such humility. It is rather that I have found no infallible method of measuring business tax burdens, and without a methodology it is as impossible to measure past tax burdens as to predict future burdens. We have, however, made some progress in analyzing methodological problems, and we hope that an exposition of the subject will not only furnish factual data of questionable interest to economic historians but will also facilitate the work of those who seek to measure carrier tax burdens in the post-war era.

This introduction is intended to convey the impression that I still have an open but not altogether empty mind on the subject which I was employed by the Board of Investigation and Research to study under the Congressional directive set forth in the third paragraph of the first subdivision of Section 302 of Part I of Title I of the Transportation Act of 1940.[1] Your constructive

[1] "It shall be the duty of the Board to investigate . . . the extent to which taxes are imposed upon [rail, motor, and water] carriers by the United States, and the several States, and by other agencies of govern-

* *1943 Proceedings,* National Tax Association, pp. 125–141.

criticism of this paper is invited with the assurance that it will be helpful in reaching final conclusions on the problem of carrier tax burdens. As a federal employee, I am obliged by custom and by the rules of etiquette to add that I speak for myself and not for the Board of Investigation and Research, but I am sure that they share my hope that the scheduled papers will be followed by free and open discussion from the floor.

Standards of Overtaxation

The terms "overtaxation" and "undertaxation" imply a standard against which actual tax payments are measured and found to be excessive or deficient. This standard appears clearly to be relative rather than absolute. It is true we sometimes say that business as a whole is overtaxed. But we usually either carefully qualify such an assertion or say it in a loud voice intended to carry its own conviction. Few have attempted to determine how the total tax load should be divided between individuals on the one hand and business concerns on the other, and none has been fully successful.[2] Instead, the quantitative treatments of business tax burdens have been confined to geographical studies intended to show where an industry will locate if it wished to minimize its tax payments and industrial studies designed to show whether butchers are taxed more heavily than bakers and candlestick makers. Both of these are questions of relativity. It is, of course, the latter which is pertinent to the present discussion.

What standards do we employ when we say that butchers are taxed more or less heavily than bakers? Several have occurred to me. First, there is the standard of legal liability. If the baker's tax agent is less ethical and his tax administrator less adamant than their respective colleagues in this audience, the butcher may succeed in getting tax concessions to which he is not legally entitled and which are not accorded the baker. Most of us would agree that the baker is then relatively overtaxed, in a legalistic sense of the word. It is overtaxation of this type of which the railroads complain in many of their property tax suits and which they seek to prove by evidence tending to show that locally assessed property is listed at a much smaller fraction of its true value than state-assessed railroad property.

But overtaxation surely does not result solely, if indeed it results necessarily, from the failure of one's competitors to pay the taxes which the law contemplates that they shall pay. Such a limited definition of overtaxation would ascribe to legislators an omniscience that few of them would claim now that the elections are over. The fact that the legislatures themselves, on both the state and the federal level, have often sought the advice of special tax study commissions is sufficient proof that tax laws are not divinely inspired, though there are those who believe that the inspiration comes from supernatural sources of less enviable reputation.

In their efforts to prevent overtaxation, our state and federal legislatures seem to have been guided in the main by a second standard which is well illustrated by the so-called

ment, including county, municipal, district, and local agencies."

[2] See R. W. Nelson and Donald Jackson, "Allocation of Benefits from Government Expenditures," *Studies in Income and Wealth*, II, 317 ff., for a statement of the limitations of an approach to this problem.

"uniformity rule." It is difficult to define this standard in precise terms, but it appears to require that like tax objects, such as buildings, machinery, sales, and what have you, be universally taxed at uniform rates. These requirements are met, in at least formal respects, I presume, by a specific tax of $50 each upon all carrier equipment units, although such a tax would be vastly more onerous to the motor carriers than to the rail and water carriers. And surely the requirements of uniformity are satisfied by a flat-rate ad valorem tax on all privately owned real estate, although the railroads would argue persuasively that such a levy burdened them much more than their competitors. Thus the uniformity concept is of little help in formulating nondiscriminatory tax policies because discrimination can arise from the selection of tax objects as well as from the application of differential tax rates or the failure to give a tax universal application.

There remain two standards that are related but nonetheless distinct. When we say that an industry is overtaxed, we might conceivably mean that the taxes collected from that industry bear unduly upon those to whom they are finally shifted. If poor people, for instance, ate little or no meat but much bread, a fully shifted gross earnings tax of uniform rate might be said to result in overtaxation of bakers because by assumption its incidence is upon the less fortunate members of the community. But I think it is clear that this is not the standard ordinarily employed either by students of business tax burdens or by business men. Instead, it appears that our usual standard is embodied in the concept of a "neutral" tax system —that is, a system in which taxes have the least possible effect upon the direction and extent of business enterprise. Under this concept, the baker is overtaxed relative to the butcher if the effect of the tax system has been to divert labor and/or capital from the baking business to the butchering business. Or, to return to the transportation industry, railroads may be said to be overtaxed if the tax system has tended to divert traffic from the rails to the highways, the waterways, and the airways.

Acceptance of the neutral tax system standard as the test of over- or undertaxation does not necessarily imply antipathy to the use of taxation as an instrument of social and economic control. It merely implies that the use of taxes for this purpose should be deliberate. It may be found, for example, that the tax system has contributed to the expansion of water and air transportation. This raises the questions whether subsidization of these two carrier groups is desirable and whether the subsidy should take the form of "undertaxation"; it does not answer the questions.

There are, unfortunately, no finely calibrated instruments with which to measure the effect of taxation upon the flow of labor and capital into different lines of economic activity. So far, we have been unable to improve much upon the traditional method by which taxes are expressed as fractions of gross earnings, net income, or some other evidence of taxable capacity, and the subject of comparison that comes out with the highest ratio is said to be handicapped in the competitive struggle. We are dissatisfied with this method for several reasons, of which I will

mention two at this point: (1) It assumes that a "tax is a tax" whatever the base on which it is levied, whereas it appears that different types of taxes have different probable effects upon the growth of an industry; (2) it assumes that taxes and the selected evidence of taxable capacity are independent variables or are uniformly related for all subjects of comparison, whereas the subjects of comparison necessarily operate under somewhat different cost and demand conditions and will therefore experience different price, revenue, and income effects as the result of their subjection to a given tax increment.

* * * *

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LLOYD P. RICE

The Place of Payroll Taxes in Financing Social Security

SINCE 1935, social security taxes based on payroll have come to occupy an important place in the American revenue system. In the selection that follows, the rationale of these taxes and some of the problems raised by their addition to the tax system are discussed.*

The Federal Social Security Act is a landmark in social legislation in the United States. It points the way to a new era in economic security. To wage earners, it holds out the hope of greater security in old age and for limited periods of unemployment. To business men it means stabilization of purchasing power during periods of depression; it also means new taxes whose first impact is largely on the employer.

From a fiscal viewpoint, the security act means the expansion of government functions due to a changing political philosophy. New services mean added expenses and new bureaus. Financing these enlarged social services requires new taxes which it is estimated will cost within a decade approximately four billion dollars annually. The improved services should promote national welfare; but the accompanying taxes may have far-reaching and unforeseen economic effects upon the organization of business and business profits or upon wage rates or prices.

The humanitarian purposes of the legislation are universally applauded. The inadequacies and imperfections of the initial act are

* "Financing Social Security by Means of Payroll Taxes," *How Shall Business Be Taxed?* (New York: Tax Policy League, 1937), pp. 135–153. Reprinted by permission of the Tax Institute, New York.

generally acknowledged. The financial aspects of the problem, however, are much less commonly understood. They are often neglected, and their varied effects are rarely appreciated even by close students of the problem.

Payroll taxes are the very lifeblood of the social security program. In financing social security they are comparable in importance with property taxes in the support of state and local functions, with gasoline taxes in the construction and maintenance of highways, and with income taxes and excises in the maintenance of federal services. They are the main financial support of the old age and unemployment provisions of the act. The term "payroll" is used here in a broad sense, including both the excise tax imposed on employers and the income tax levied upon the wages of workers.

What part of the social security program will be financed by payroll taxes? Are they an adequate and reliable support for the Federal-state social security structure? Are they the most suitable, or available foundations for social security? How much reliance will be placed upon them compared with taxes with which we are now familiar? Will they be borne by the persons who pay them in the first instance, or will they be shifted? Who will ultimately foot the bills? Will it be the employer who will have to be satisfied with lower profits, the laborer who will have to accept lower wages, or the consumers (including laborers) who will have to pay higher prices? How will the payroll taxes affect the character of Federal and state tax systems and the distribution of Federal and state tax burdens? These are some of the questions that ought to be considered.

It should be pointed out that only a part—perhaps not over half—of the sum total of funds required to support the needy aged, the unemployed, and to provide certain other types of social security will be raised by payroll taxes. Other taxes—primarily the old reliable property tax and income and sales taxes—must provide the support of all the needy aged, of all the aged and unemployed in excluded occupations, and of those unemployed who are covered by the act after they have exhausted their benefit payments.

A comprehensive treatment of the fiscal aspects of payroll taxes and a fair valuation of their probable effects demands the consideration of these complex and baffling questions. Neither the limits of this paper nor the time and resources of the writer permit the thorough examination and research which the subject merits. It is the purpose of this paper primarily to raise major issues, to suggest some of the possible variations in the incidence and effects of payroll taxes, and to attempt a tentative evaluation of these taxes when related to the benefits proposed, the complementary taxes involved, and the canons of a good tax system.

* * * *

Payroll Taxes Justified as Valid Application of Benefit Principle

When unemployment insurance benefits run out, the state will step in and contribute some form of relief, whether through a dole or some form of work relief. In periods of prolonged unemployment, payroll taxes will cover only a small part of the costs of caring for the unemployed. The state will therefore be a major contributor out of general

tax revenues. Even borrowing does not shift the burden from taxpayers. It merely postpones the date when the tax bills are sent out and increases their amount. Benefits for the aged will likewise be provided to only a limited extent from payroll taxes. The entire cost of old age assistance must be met out of general taxes, Federal and state. And after 1967 over $1,000,000,000 annually must be secured from Federal taxes to meet interest payments on the reserve fund debt, unless these provisions of the act are abolished or materially altered.

The use of payroll taxes is therefore a limited application of the benefit principle: based on the belief that certain costs may fairly be assessed in part upon direct beneficiaries of government activities. Far from being a discarded or obsolete principle, it is being increasingly recognized as sound and valid. It may advantageously be used to supplement the ability and fiscal theories over important areas of the field of state activity. It is being applied here not only in order to make the security program partially "self-sustaining." It is essential in order to make it possible at all on a broad scale under present conditions. The principle has a valid place in the social security program; but this argument does not justify the practice of levying heavy taxes upon wage earners in the next decade in order to relieve a future generation of part of the cost of its security.

The limited use of payroll taxes to finance a minimum of social security is comparable in every way to the use of gasoline taxes to provide a more adequate, up-to-date, coordinated system of hard-surfaced roads. If we had relied solely on state income taxes—that is, on the ability principle for highway construction and maintenance—we should now be driving automobiles over horse and buggy roads.

Payroll taxes are no more unjust or burdensome than are gasoline taxes. They are not used to build useless battleships or for boondoggling. They are more accurately described as compulsory savings than as taxes in the ordinary sense. Every cent paid out by labor in old age taxes will be returned in the form of an annuity to the laborer, or to his estate.

Unimportant modifications of this rule have been introduced for valid reasons. The younger workers will subsidize older ones to some extent; and higher salaried employees will likewise subsidize those receiving low wages. For a few years the Federal Government may derive some general funds from the 3 per cent tax for the unemployed which has been paid by employers in states which have not adopted an unemployment compensation system. In all cases ten per cent of this tax will be retained indefinitely and this may be more than sufficient to cover the costs of administration.

Supplementary Taxes: Their Importance and Possibilities

In addition to the payroll taxes, other taxes approximately equal in amount must be raised sooner or later in order to carry out the social security program as a whole. These funds must come from general tax revenues of state and national governments. They will be a partial though not a complete addition to current taxes for similar functions.

What are some of these other unnamed taxes upon which the security program partially rests? The main

reliance of the Federal Government is and will continue to be income taxes and special excise on semi-luxuries, supplemented by estate taxes and customs duties. On the whole this system is probably moderately progressive; in the upper brackets it is highly but unevenly progressive. Contributions from the United States government will come from these taxes in unpredictable proportions in order to meet at least part of nearly every one of the services. Increasing emphasis is being placed on taxes on the wealthiest individuals and on the larger corporations. Further increases in revenue must apparently come largely either from persons of moderate means, in increased normal taxes, or from those now untaxed, by lowering the exemptions. Both of these changes are economically and fiscally desirable and are overdue; but they have appeared to be politically inexpedient if not impossible up to the present time. The payroll taxes will be complementary to the income tax in this respect. In combination, they should prove a more stable and reliable basis for the security program than exclusive reliance on either one alone.

Some social reformers will disagree with this conclusion. They naively assume that the costs of social security can actually be met merely by increasing income taxes in the upper brackets. And they regard this as desirable because of a blind faith in the ability theory. Since the Federal Government now takes an average of 65 to 70 per cent in the highest income tax brackets, and other taxes—state and Federal—must be added to this, it is a delusion to believe that a social security program comparable in scope with the present act can be financed largely by taxes on the wealthy. The funds would be utterly inadequate. It would be offering the needy aged and the unemployed a stone when they ask for bread. There is nothing in the act, however, to prevent as heavy a reliance on income and inheritance taxes as is fiscally and politically feasible. Contributions from the aged might be reduced somewhat. But without payroll taxes, revenues would be too inadequate a foundation on which to build a four billion dollar superstructure of benefits.

If one compares payroll taxes for the support of old age with property taxes as administered by most states today, payroll taxes should receive a high rating. A 3 per cent payroll tax may be paid out of income, even if it is distressingly small. Property taxes have often been levied in recent years when there was no income whatever. That has been true in many farming communities for nearly a decade, and elsewhere. Moreover property tax rates are often as high a percentage of assessed value as the direct payroll tax on wages is of income. As a percentage of one's income, property taxes often absorb one-third or one-half of the income. To transfer an increasing share of the social security tax load upon the states would mean a more complete breakdown of property taxes which are staggering under their present load. It would mean greater reliance upon objectionable sales taxes, and a small amount from income taxes. However desirable income taxes may be, they cannot be expected to produce in the near future anything like the prodigious sums required for financing social security or even for meeting the costs of other state and local activities: the difficulties are constitutional, political, economic and administrative. The development of income taxes

as a major source of revenue will come slowly in states with which I am most familiar.

Payroll taxes should therefore be retained to a large extent. They will prove immensely productive. They can be justified on valid grounds as one element in financing social security, even though they may generally be borne by wage earners. Supplementary revenues should be drawn from income taxes so far as that is politically feasible and fiscally possible. A union of diverse tax sources will strengthen the entire social security program. With payroll taxes, a measurable degree of security seems possible. Without them it would appear to be impossible in our time.

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GEORGE B. ROBINSON

Old-Age Insurance Reserves

ONE of the controversial financial aspects of the social security program is the reserves for old-age insurance. The original plan contemplated a very large reserve to be built up in the early years of the program. The 1939 revision of the plan reduced the size of the reserve to contingency proportions. In this selection, which constitutes only a part of the original, the author argues that Congress amended the act on fallacious grounds and insufficient accounting and actuarial evidence. The act, in his judgment, needs a fresh reviewing. Some of the supporting argument follows: *

The 1939 Alternatives

With the reserve-fund expectation destroyed by the new calculation that had added 50 per cent to probable costs, a choice among three alternatives was necessary. These alternatives were:

A. To restore the 1980 reserve-fund expectation by increasing the old-age tax rates by 50 per cent for immediate effect, that is to say, from the scale 2 per cent to 6 per cent, to a scale 3 per cent to 9 per cent.

B. To restore the same expectation by enacting immediate general tax subsidy for one third of the old-age costs, that is to say, a subsidy equal to 50

* Reprinted by permission from "Old-Age Security and the Treasury," *Journal of Accountancy*, LXXIII, No. 1 (Jan. 1942), 7–24.

per cent of the old-age tax receipts, such sums to be additional to the old-age collections at the existing tax rates.

C. To abandon the purpose of accumulating such a reserve fund.

Neither A nor B offered a very pleasant choice. Under either, the said approximate $50,000,000,000 possible over-estimate of 1980 reserve accumulation must have been confessed in detail. Such confession would not have been complimentary to the original planning of the act nor too compatible with the beneficence which was being claimed for it.

Alternative B would have required also an immediate enactment of general-tax subsidy to the program—a difficult legislative task, presumably, because of the many occupational exclusions, notably that of agriculture. Agriculture's support of the act had been given on the premise that it was a self-supporting program. Although we have now had the act for six years, no satisfactory way to include farm proprietors and other self-employed persons has been suggested. It is doubtful that any can be, because the tax base of the act is wages, and the self-employed do not receive wages. Our farmers and other unincorporated enterprisers were likely to think, therefore, that general-tax subsidy amounted to a modern version of taxation without representation.

Alternative C, however, offered an easier course. Taxes might even be reduced, if the reserve effort were abandoned. True, there was the obstacle that the Treasury had proposed the reserve effort originally. The Treasury, presumably, would have to find good reason to reverse its position. There were many persons, however, who had opposed the reserve program originally, or criticized it since, on several grounds, and these opinions were ready and waiting to come to the enlightenment of the Treasury. In this presentation of arguments the Treasury and the public were asked to believe several quite unbelievable views.

Partitioning the Treasury

Several such views appear to have had a common source. That source was in not having observed (or in not having *invariably* kept in mind) that the social-security act had virtually *partitioned* the Treasury into two parts. One part may be spoken of as the Fisc. It has to do with all Treasury matters except the old-age pension system, and is supported by the general taxes. The other part may be called the Insurer. It has to do with the old-age system exclusively, including the investment of its moneys. It is to be supported by the old-age taxes, with or without aid from general taxes. It is necessary that all discussion of the reserve question should take account of this partitioning, because the reserve fund itself expresses only a relationship between the two divisions of the Treasury and the two sets of taxpayers, as established by the statute and its operation.

Without notice of this *partitioning*, it was said that a reserve fund of government bonds was "fictitious" or "meaningless." The said fund has reality and a definite meaning in the fact that it represents a lien on the general-tax system in favor of the old-age system, acquired for value paid. Strangely, several critics of the reserve program who regarded this lien as fictitious approved the granting of a lien on the general-tax sys-

tem in favor of the old-age system through the enactment of a general-tax subsidy. The result of holding both these views is to treat such a lien as fictitious in the argument against a reserve fund but as valid in the argument for subsidy. These writers cannot have it both ways. The lien will be the same in both cases, except that in the latter case it would be only for an annual income, whereas in the former, the lien having been bought and paid for, it will be for the principal sum involved, as well as for the annual income arising from the interest thereon. It will be a valid lien in either case, an asset of the said Insurer and its group of contributory taxpayers and beneficiaries, and a liability of the said Fisc and the general-tax payers.

The Treasury was accused of having proposed the reserve plan for "ulterior reason," namely "not for social security but to retire the government debt." Another critic said that old-age moneys would be used, improperly, "to pay off past securities." Both criticisms dealt with the effect of old-age accumulation under balanced budgets. The said charges were identical, because "to retire debt" ordinarily means to pay it, and it would only be as such debt should be "paid off" (and therefore canceled) that any charge of diversion of funds from the old-age purpose, such as would establish either the said impropriety or the said "ulterior reason," could be valid. The statute, however, provided to the contrary. It provided that bonds bought for the reserve with old-age moneys should be kept alive with their lien on the general taxpayers intact.

True, in 1935 Secretary Morgenthau had spoken of "retiring a large part of the public debt" with old-age moneys. He had spoken, however, in terms of a total, unpartitioned Treasury. The bonds would be *retired* inside the Treasury's walls, but only to be held there alive for old-age purposes. They would not be *retired,* in the sense of being paid and canceled. The said criticism, and the accusation of "ulterior reason" appear to have addressed Secretary Morgenthau's phrase rather than the statute itself. If the statute had provided that such bonds should be canceled the criticism would have been valid, but the statute did not so provide. It is this provision of the statute, indeed, the provision which requires that the said bonds be held alive as a purchased lien on the general taxpayers, that accomplished the said *partitioning* of the Treasury, and made improper any discussion of the reserve question which does not recognize it. It should be noticed that with the word "retiring" in Secretary Morgenthau's phrase taken to mean "recovering into an old-age reserve account in the Treasury," this being the only meaning which the statute itself fulfills, the said partitioning is recognized and all "ulterior reason" vanishes. There are, under the statute, only two possible destinations for old-age moneys. These are old-age pensions, and investment to earn interest for old-age pensions.

The Treasury was said also to have wanted a reserve as a source of supply of moneys for fiscal expenditure. This charge was the deficit budget complement of the balanced-budget charge just discussed. It failed to take into account the circumstance that the said tax receipts can only be appropriated once. The said old-age tax receipts are appropriated to

the old-age reserve fund, for old-age purposes, and that is the end of them as a disposition of tax receipts. True, such appropriations are followed by investment by the Insurer in bonds of the Fisc, and in such investment the Fisc receives back sums equal to the appropriations minus any current old-age disbursements. It receives them back on new terms, however, not as tax receipts but as borrowed money, and it is as borrowed money that they may be appropriated for fiscal expenditure. So far nobody has said that individuals should not save money for deposit in savings banks and insurance companies, to be invested by such depositories in government bonds, on the ground that the Treasury wants such moneys for expenditures. The cases are identical, however.

The argument on this point abounded with misleading phrases. When it was charged that the Treasury was using old-age moneys for fiscal expenditures, or to finance its deficits, it was often said that the process of tax receipt, appropriation, investment and borrowing, and a second appropriation amounted to "mere bookkeeping transactions," or that the Treasury "set up" or "wrote up" bonds. All such phrases suggested a fictitious process. The fiction was not in the process, however, but in the phrases. Neither "bookkeeping" nor "transactions" can possibly be "mere." There are only "transactions," and the necessity to enter them in books of account. In this case there occurred the said four successive transactions. The second and third of these took place between the two divisions of the Treasury, leaving a remainder of a lien on the fiscal system, bought and paid for by the old-age system. The Treasury cannot "write up" or "set up" bonds. It can only honor the appropriations made by Congress, borrow money as the Fisc, and invest money as the Insurer. The said phrases were phrases of a whole, or consolidated, or unpartitioned Treasury, and they ignored the fact that the reserve fund is itself the product of a partitioning of the Treasury and must be discussed invariably with full recognition thereof. The said phrases addressed a Treasury which no longer exists, the Treasury having been changed structurally by the act. If any further demonstration of that fact were needed, the said phrases themselves would provide it, in their obvious departure from describing any act the Treasury could legally perform.

The Treasury was told erroneously that interest on government bonds in the reserve fund was a form of general-tax subsidy, and therefore that such subsidy was already provided for in the statute of 1935. The said interest on the contrary is *earned* by the investment of the old-age moneys, and is paid by the Fisc for the *use* thereof. For such interest *no appropriation to the reserve fund* is necessary. The fund merely receives part of the moneys which are *appropriated to pay interest* on the government debt, that total sum being an amount which must be appropriated, fund or no fund. Subsidy, on the contrary, will require a specific *appropriation to the fund.*

* * * *

Suggestions

It is recommended that the Treasury now publish estimates of the annual cost of the program, as such cost was treated in Secretary Morgenthau's 1935 statement, and of the

present accrued liability for pensions, such publication to be made pursuant to the Treasury's duty to maintain the public credit by forthright statements of its affairs. These important figures have been missing from the outset. It is thought that such publication is imperative in order that the future debt for pensions may be contemplated in advance of its maturities.[1]

It would appear that the proper manner in which to make such an acknowledgment of accrued liability would be (1) to publish a separate debt statement of the Treasury as Insurer under the old-age program, such statement to be attached to the ordinary debt statement of the Fisc, whenever published, and (2) to express the same debt, as a contingent liability, in a footnote to the debt statement of the Fisc. It may be debatable whether the pension debt is a contingent or a direct liability of the Fisc, the total government having promised to pay the pensions; but it would appear to be satisfactory to treat it merely as contingent on the grounds (1) that the amount is not known exactly and can be expressed only by estimate, (2) that a special tax program has been enacted from which the Insurer, with or without the enactment of some specific amount of general-tax aid, is expected to derive sufficient revenue to discharge it, without further drafts on the general funds, and (3) that it would be treated as a direct liability in an accompanying debt statement of the Treasury as Insurer.

It is urged that the "partitioning of the Treasury" which is described herein should be recognized and invariably kept in mind in discussing the old-age subject. It has been not less than devastating to the development of the program to treat a reserve fund as either unneeded or fictitious. Publication of the liability for pensions would quickly show the need for accumulations. The reality of the fund becomes evident when the said partitioning is kept in mind, that is to say, when it is recognized that accumulation acquires for the old-age program, for value paid, certain liens on the general tax system which will be outstanding in any case.

To refer again to the hypothetical case of an old-age program enacted in 1900, a reserve fund which should have accumulated $40,000,000,000 of 3-per-cent government bonds by 1941 would now have an annual income from earned interest of $1,200,000,000 a year, such income supplied wholly out of the present appropriation for bond interest. Without

[1] Arthur J. Altmeyer, Chairman, Social Security Board: *Hearings before the Special Committee to Investigate the Old-Age Pension System, United States Senate, 1941,* p. 68: ". . . it must be remembered that the insurance system is now incurring a tremendous liability for payments which will become due . . . for many years in the future."

W. R. Williamson, Actuarial Consultant, Social Security Board: *The Annalist,* September 5, 1940: "It is not necessary to use in social insurance accounting the accruing liability concept of the employer whose pension commitments may well outlast his very corporate existence. The whole country expects to continue in existence and to back up its programs . . ."

And: "It is not essentially realistic to apply . . . the single employer's advance funding under a pension plan to a program of this magnitude and of this presumptive perpetuity."

The "tremendous liability" which Chairman Altmeyer here said "the insurance system is now incurring" is the liability urged herein to be estimated and acknowledged by the Treasury. The case for no recognition thereof, as thus stated by Mr. Williamson, appears to rest heavily on presumptions which beg the questions involved.

any fund, 1941 appropriations *to the old-age purpose* would have to be $1,200,000,000 larger. The said fund possesses all the reality portrayed by this circumstance. The interest income it earns, and the principal if necessary, will save appropriations *to the old-age purpose.*

It is suggested that the question of general-tax subsidy to the system be faced at once. The Advisory Council offered a justification of such subsidy by saying that the public, as distinguished from the insured group, would benefit from the program and therefore should pay part (one third) of its cost. The Council specifically made such subsidy a condition of the abandonment of the reserve effort, but although the latter was enacted the former was not. The result is accordingly confused if not chaotic. If, moreover, the Council's view is accepted as equitable it has become inequitable to tax exclusively within the system. It seems necessary, if such subsidy is to be enacted, to build it into the program instead of reserving it to be invoked when pensions shall have become due and payable.

It is urged that if any equitable method of covering the self-employed, including the farmers, has been discovered, it should now be promulgated. Our total national economy is such that the act's present presumption that wage earners, but no others, will be needy (and therefore entitled to bonuses) at age 65, is not persuasive. To be equitable, however, any method which may be proposed must do more than to extend the bonuses to include the older members of any additional occupational group, with added burdens on the young and future members thereof, and on general taxation.

It is suggested that the amount of governmental waste involved in presuming all insured persons to be needy at age 65 be estimated for study. Title II makes this presumption and the act relies upon it for justification of the bonuses. It seems clear that all bonuses which are now being paid and shall be paid to persons who do not need pensions constitute governmental waste.

It seems apparent that if the present program is to persist, a present old-age tax increase, or the enactment of general-tax support, or both, is imperative, for the purpose of getting on with the financial validation of the very large and rapidly maturing pension promises. Such action is so obviously required on old-age security grounds alone that there is little point in borrowing supporting arguments from other areas. A tax increase would possibly retard "inflation," to be sure, but to give primary importance to that argument would be to ignore the need to decide old-age questions on principle in the simple traditional area of paying current costs currently so far as possible. It is thought, moreover, that a tax increase proposed on old-age security grounds alone would be more acceptable to the taxpayers than one which should be put forward to any considerable extent as a step in monetary management or adventure. At the least, consideration of the proposed tax increase primarily within the old-age security area would serve a greatly needed notice that old-age security is not now an accomplished fact, but must be paid for to be enjoyed.

If instead, however, the Treasury rests its case wholly on monetary grounds, it is urged that there be included therein a full description and

documentation of that new orientation. On what grounds, discovered since 1935, does the Treasury presently believe that old-age taxation has primary reference to monetary control? What, in that case, is the Treasury's formula for monetary control, and does the Treasury propose adherence to it, even at the risk of "placing all confidence in the taxing power of the future" if the condition of trade should again so direct?

It is urged, however, that there should be no tax increases and no extensions of coverage until there has been a full review in Congress of the 1939 decisions, and of the present resulting position of the act in respect to questions of equity and of finance, in the light of the important data not then available to the debate. Increased taxes for a few years, to be followed possibly by decreased taxes if the business conditions should change, will not cure the act's present ills, and extensions of coverage without such cure can only compound them. The old-age cause is magnificent.

It would be a great pity for it to be wrecked on the shoals of financial decisions reached, as in 1939, without due attention to the accruing liability for pensions, the magnitude and meaning of the bonuses, the significance of the discovery that costs had probably been greatly underestimated in 1935, and the intimate relation of the form of the old-age program to the Treasury's fiscal condition and prospects. Without these considerations being in the foreground of the discussion the 1939 decisions could be reached only in great confusion and by much rationalizing, and the old-age purpose deserves a better deal.

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ALVIN H. HANSEN

The Deflationary Character of Old-Age Insurance Reserves

IN SHARP contrast to the foregoing view, Professor Alvin H. Hansen, in 1938, criticized the social-security-reserve program as follows: *

The manner in which these [old-age security] taxes tend to reduce the total volume of expendable funds below what they otherwise might have been may be briefly stated as follows: Consider the situation if the federal

* Reprinted from *Full Recovery Or Stagnation?* by Alvin H. Hansen, by permission of the publishers, W. W. Norton & Company, Inc., New York. Copyright, 1938, by the publishers. Pages 191–192.

budget is in balance. In this event the funds flowing into the Old-Age Reserve Account will, directly or indirectly, be used to retire the volume of government obligations outstanding in the hands of the banks and of the public. In the event that the bonds so retired are held by the banks, as the investment assets of the banks decline, deposits decline. In the event that the bonds so retired are held by the public, the cash received by individual or institutional investors might be used for consumption or investment expenditures. However, if a recession is already in process, it is well known that the tendency is to pay off debt or to hold such funds idle, employing them neither for consumption nor investment purchases. Thus, whether the banks' holdings of bonds decline or those of the public generally, a deflationary influence is exerted on total investment and consumption expenditures.

Assume, on the other hand, that the government deficit is exactly equal to the amount of the Old-Age Security taxes. In this event it is of course true that the funds derived from these taxes will be used by the government to cover the deficit. Presumably, however, such deficit-creating expenditures would have been undertaken in any event, with or without an Old-Age Reserve Account. What must be clearly recognized is that by drawing in tax funds in a period of recession, deflation is accentuated, thereby calling for still heavier governmental expenditures to check the downward movement. If the country is already facing recession difficulties, the present plan unnecessarily adds to our troubles by draining off a part of the consumption expenditures which would otherwise have been made.

The continued accumulation of the trust fund forces a net addition to the volume of savings. The former holders of the government securities purchased by the Trust Account are forced to find other investments. During a depression the volume of idle funds—hoards which cannot find investment outlets—would be increased.

During the prosperity phase the accumulations through the retirement of publicly-held government debt would have the effect of pouring additional funds into the capital market. Nevertheless, this result would not inevitably follow from the present plan. The Treasury might, instead of retiring outstanding debt, sterilize, in whole or in part, the funds received from its sale of special issues to the Old-Age Reserve Account. The sums could be left as demand deposits with the commercial banks or transferred to deposit account with the Federal Reserve banks. The latter procedure by reducing member bank reserves would act as a powerful restraint upon undue expansion. In a subsequent depression the sterilized funds could be de-sterilized and used to finance public works or relief expenditures. But taxes currently received during such a depression period could only contribute to the deflationary tendencies, thereby necessitating still heavier relief and public works expenditures.

GEORGE S. WEHRWEIN

Appraisal of Special Forest Crop Taxation in Wisconsin

SPECIAL problems of taxation occur in the application of the tax system to the extractive industries, particularly those engaged in exploiting natural resources. One section of this field covers the taxation of forests. In 1927 Wisconsin designated forests as a special class of general property and provided special tax treatment for this class. The experience of the state with its forest crop law was discussed by Professor George S. Wehrwein as follows: *

Land use adjustments seem to be exceptionally acute in the twilight zones between established land uses —the farm—forest fringe, the area between grazing and plow farming and in the rural-urban fringe as indicated in the two previous papers. It is not generally appreciated that the break in land uses on the farm-forest fringe, generally speaking, also means a break in ownership, from private to public. That private investors have lost faith in the use of land for any profitable use when the land falls below the agricultural margin is proved by the mounting tax delinquency on the fringes, and the reversion of this land to involuntary county or state ownership. This means public land management, reforestation, and the supplying of public services for an enormous nontaxpaying area in precisely those sections of the Lake States least able to do so.

Tax reversion raises the question of how to satisfy the claims of various levels of government on a given parcel of delinquent land (since only one unit can become its owner), the question of payments in lieu of taxes and the sharing of the income from the land with the other units.

It is against this background that the Wisconsin Forest Crop Law must be appraised, not by itself, but as "one tool in a kit of tools" which has functioned as a means of land use adjustment, land management and the slow and halting reorganization of local governments. Its original objective was to assist and encourage the practice of forestry by private enterprise on the supposition that the general property tax was not suited to forestry in private ownership. As intended to operate, it can hardly be called a subsidy such as the Wisconsin wood lot exemption law frankly is, since the state expects to recover its contributions to local units through a severance tax levied at the time of cutting. The land owner pays 10¢ an acre, representing a tax on the land only, and the state pays 10¢ an acre, the

* *1941 Proceedings,* National Tax Association, pp. 619–628.

20¢ going to the towns to be divided as follows: 40% to the town, 40% to the school districts (in proportion which the forest crop lands of the district bear to the total forest crop lands of the town) and 20% to the county. The land owner can thus be said to pay part of his taxes annually in the usual manner, the rest being deferred until he harvests his crop, at which time he pays 10% of the stumpage value to reimburse the state for its payments to local units of government. At that time the books are expected to be balanced.

The law, however, is set up to promote commercial forestry. The Conservation Commission is empowered and has the duty to examine the land within five years after entry and reject all land better suited to agriculture, mineral, recreational or other purposes on the one hand, and also land not considered good enough for commercial forestry. It is expected that the stumpage value at the time of cutting will be enough to repay the state for its contribution of 10¢ per acre for 50 years. That the Conservation Commission has exercised this right is shown by the fact that 112,000 acres of land entered by private operators have been cancelled up to 1941. Some of the cancellations were also due to the fact that the owner was not practicing forestry as called for in his contract with the commission.

From the standpoint of stimulating forestry on all land submarginal for agriculture, it is clear that the forest crop law was intended to assist forestry only on that portion capable of raising merchantable forest products which will bring returns sufficient to reimburse the state for its 50 contributions of 10¢ per acre. The law cannot be applied to submarginal forest land, and because such land is submarginal for practically all private uses it will tend to become public property via tax delinquency.

During the early years of the forest crop law entries were very encouraging. In 1928, 166,760 acres were entered and by 1932 a total of 292,947 acres was reached. Since then the new entries have fallen off and withdrawals and cancellations have reduced the figure to 150,075 acres. A small proportion consists of merchantable timber entered under the "special classification" provision under which the owner pays annual taxes and severance taxes according to special rates set up in the law. Two lumber companies and three paper mills own 71% of the private forest crop lands and if all the holdings of over 1,000 acres are totalled they represent 81% of all such lands. An encouraging feature is the fact that the lumber company which holds one third of all forest crop lands is practicing model sustained yield management, but others are "cutting clean" and are using the law to help carry their tax load. Paper companies, however, are anxious to build up reserves for the future and have done a substantial amount of planting.

Whether the forest crop laws has accomplished its original purpose of encouraging sustained yield management on matured timber and of "reproducing and growing for the future adequate crops of forest products on land not more useful for other purposes" depends on the point of view. Surely there is more land than 150,075 acres in northern Wisconsin suitable for private forestry under the definition of the act, yet it has not been entered under the law. How-

ever, the effect of the law is more widespread than these figures would indicate. Trees are being planted and forestry practiced on land not entered under the law. The operators can always fall back on entry whenever general property taxes rise too high. The cancellations, withdrawals and tax delinquency on forest crop land can also be cited as evidence to show that even after the land had been entered, private individuals lost their enthusiasm or failed to practice forestry as was the intent of the contract they made with the state.

The reasons given for the failure of private owners to make more use of the forest crop law are varied. One reason is that in many parts of the North the tax burden on land classified as "marsh, waste and cut-over" is now so low that there is less incentive to take advantage of the 10¢ maximum provided by the forest crop law. Perhaps with changed conditions modifications should be made in the law so as to make it more attractive to woodland owners. On the other hand, experience with forest crop laws in general seems to indicate that taxes are not the deterrent to private forestry that we once thought they were. The failure of private owners to practice forestry must be laid to other causes. Now that the obstacles of fire and taxes have been met the chief economic stumbling block is probably the need for long-term low-rate credit similar to that provided for agriculture. However, lumber companies, who though under the forest crop law are clear cutting, claim that the overhead of a large mill and extensive equipment is such that the only economical practice is to cut out as rapidly as possible. With the constantly growing areas of publicly owned forest land, many timber operators and other wood users also feel that their future supply of timber is secure, and therefore it is not necessary for them to engage in forestry on their own lands.

Whatever may be the verdict in regard to the success of the forest crop law in getting land into forest use under private enterprise, the law has been a marked success in helping to establish forests on county owned land. Counties were reluctant to take title to the millions of acres of land that became tax delinquent after 1920 in the cut-over region. The first reaction, which still persists to some extent, was to get the land back on the tax roll. However, private owners refused to redeem their properties and investors failed to buy tax certificates. The reluctance of the county officials to take title was rational. The land was thereby removed from the tax base of the state, county, towns, and school districts, but their unwillingness to take title to tax delinquent land was tempered by the fact that by so doing they removed fictitious assessment valuations, reduced excess delinquency, and facilitated budget making. Nevertheless, ownership involved land management, putting it in a productive use, guarding it against trespass and providing the area with public services. This in turn meant additional funds, personnel and technical knowledge for the countries with the smallest financial resources for such tasks. The forest crop law helped to solve this problem.

Since 1928, at first under a ruling of the Attorney General and after 1929 by an amendment to the original act, the Conservation Commis-

sion has accepted county owned land for entry under the law. The state pays the usual 10¢ per acre to the towns divided on the 40–40–20% basis, but the county does not pay the 10¢ an acre required of the private land owner nor is it subject to "back taxes" whenever it withdraws its land from entry. On the other hand, the county is subject to a 50% severance tax instead of the 10% paid by a private entryman because of the forestry aid law to be discussed presently. The other features of the law are much the same; the county is expected to practice forestry and the Conservation Commission has the right and duty to reject submarginal forest land, land poorly blocked up or which in other ways fails to meet the standards set by the commission. It should be pointed out that none of the three levels of government is obligated to spend its proportion of the forest crop money, whether paid on county or private land, for forestry purposes. Furthermore, the county gets only 20% of the so-called "payments to the towns" yet the entire burden of managing tax-reverted land for forests or recreation falls upon the county.

To assist counties in their forestry work an act was passed in 1927 providing for the establishment of county preserves, and outlining the powers of county boards. This law was amended in 1931 to provide for the payment of 10¢ per acre per year on all forest crop land in county ownership and in established forest reserves. It should be emphasized that this "forestry aid" money is entirely separate from the state's contribution to the towns under the forest crop law, that it comes out of another fund entirely, and is earmarked for "the purchase, development, preservation of such (county) forest reserves." These two complementary laws are the basis for county forest management or more correctly *cooperative* forestry in Wisconsin. They have stimulated counties to take title promptly to tax-reverted land and have given to the counties the necessary funds, personnel and technical knowledge for efficient forest land management. In 1931, 133,492 acres were entered by the counties, but the heaviest entries were made in 1932 and 1933. At present the total acreage of county forests operating under the two laws is 1,883,000 acres, an area approximately equal to the gross area of the federal forests within Wisconsin. At present 25 out of the 27 counties owning forest crop land have met the requirements of the forestry aid law and by January 1, 1941 the state had paid over a million dollars in forestry aids to the counties. It should be noted that mere entry under the forest crop law by itself does not make the land eligible for the forestry aids. Furthermore, not all tax-reverted land is automatically eligible for entry under the forest crop law. The Conservation Commission rejects land not suitable for commercial forest production or cancels entries if the provisions of the forest crop law or forestry aid acts have not been carried out. Almost 123,000 acres of county forest crop land had been cancelled by 1941. This means that the forest crop law is limited in its ability to assure forest management on all land submarginal for agriculture and reverting to the counties for nonpayment of taxes. By 1941, the northern Wisconsin counties had taken title to about 3,000,000 acres of which 1,883,742 acres were under the forest crop law

and eligible for forestry aid. Part of this discrepancy is due to the policy of counties not to enter all their land because they hope to sell it or use it in other ways, but by far the larger area is not acceptable under the law (principally because of "blocking requirements"); therefore the forest crop law cannot aid the counties in promoting forestry on about one-third or more of the cut-over region. If forestry is practiced at all it will be highly extensive and under unassisted county management.

Any appraisal of the Wisconsin forest crop law must consider its relationship to the zoning movement. Under the enabling act of 1923 and amended in 1929 to permit counties to zone for agriculture, forestry and recreation, 26 northern and central Wisconsin counties have set up forestry and recreation districts in which the chief prohibited use is agriculture. Under these ordinances about 5 million acres or 1/7 of the area of the state is closed to agriculture. While forestry and all other legal uses are permitted in the "unrestricted" district, forestry, mining and seasonal recreation are the only permitted uses in the restricted districts. A very significant element in zoning is that a distinct line has to be drawn between farm and forest areas, a line which, of course, can be relocated as conditions change, but nevertheless a line representing a definite cleavage between the two land uses in contrast with a shadowy transition zone.

Merely passing an ordinance, however, will not make trees grow in a forest district even though it is so named and colored a beautiful green on a map. The owner of land in a restricted district may be interested in farming and not in forestry, or his holding may be too small for this purpose, or as a land dealer he now finds that the sale for permitted uses is severely limited. However, both the forest crop and the county forest laws permit the exchange of such land with county owned land outside of the restricted district. This feature has also been used in abating non-conforming uses. For those who are forest-minded the forest crop law acts as an incentive to use the land for this permitted use. The law has given real stimulus to the counties to take title to the tax-reverted lands and practice forestry upon them. Additional impetus has been given to zoning by the policy of the Conservation Commission of giving preference to land lying in the forestry districts set up under zoning ordinances in accepting land for forest crop entry. This policy has also strengthened the feeling of local residents that forestry is not a temporary land use but that the land in county forests and in the forestry districts is definitely dedicated to forestry under land management. Furthermore, close cooperation in the administration of zoning and of county forests is secured by placing both responsibilities in the hands of one individual, in the majority of cases, the county agent, in others county land managers have come into the picture.

* * * *

In summary, it is not maintained here that the forest crop law has fully accomplished its original purposes nor that county land management is everywhere up to the standard set by a few counties or the standard set by state and federal forests at their best. It is believed, however, that the law has demonstrated its place in a "kit of tools" as a

means of getting submarginal, tax delinquent land into productive forest uses in private and public ownership, that it has stimulated local pride and initiative in the management of county forests and has assisted local units of government in this activity. It has complemented the zoning of land for agriculture, forestry and recreation, furnished a method of payments in lieu of taxes and of sharing the income from cooperative forests with other levels of government. It has not and cannot assist counties in the management of "submarginal" forest land. It is a question whether the act should be amended to be of assistance to counties in this direction or whether additional legislation should not be enacted to take care of this segment of publicly owned land.

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TAX POLICY LEAGUE

Severance Taxes

COUNTRIES and states which have extensive extractive industries frequently rely heavily on so-called "severance" taxes for revenue. Reasons for applying this form of taxation are discussed in the following selection: *

Despite the fact that over one-third of the states levy severance taxes and that some states raise 15% or 20% of the state tax revenues in this way, the layman frequently appears puzzled at their mention. The term does not convey any immediate meaning to his mind as is the case in connection with property, sales, chain store, gasoline and other taxes in general use. Had such levies been labeled natural resources taxes they would have been more easily recognizable. For the severance tax is levied upon natural resources at the time of production, or severance from the earth.

Severance taxes are relative newcomers in the tax field, their development and spread having taken place largely within the last two decades. Some of the earlier experiments were in Michigan (1846), Pennsylvania (1874), Minnesota (1881), West Virginia (1907), Texas (1907), Oklahoma (1908), Louisiana (1910), Kentucky (1917), and Alabama (1919).

Reasons for Severance Taxes

Severance taxes have proved to be productive sources of revenue in several states, but their main justification is to be found on other grounds.

The waste of our natural resources

* *Tax Policy*, VII, No. 4 (Feb. 1940). Reprinted by permission of the Tax Institute, New York.

is now generally recognized and sober-minded persons are seeking ways whereby the remaining resources may be conserved as wisely as possible.

Until recently mineral reserves, active mineral properties, growing timber and other resources were subject to the general property tax and they still are in a number of states. The difficulties of accurately assessing such property are in some instances almost insuperable. Moreover, the necessity for current funds out of which to pay annual taxes tended to speed up resources production in a manner that is frequently highly wasteful.

In its 1934 report, the National Resources Board stated: "Of all taxes on minerals, the one which is most likely to be anti-conservational is the ad valorem tax. The effects of this tax are cumulative, and some of them are only beginning to be recognized. . . .

"Owners of mineral resources are driven to open mines in order to provide income enough to meet their taxes, and the ad valorem tax has been one of the causes of overdevelopment of mine capacity, especially of coal mines. It has a tendency to force selective mining with attendant loss of low-grade material. It handicaps the development and extraction of the miscellaneous grades to be found in most mineral districts. It puts a premium on the use of methods of extraction which cost the least, regardless of the fact that these methods often involve the permanent destruction or locking up of important reserves costing more to extract."

With respect to the effect of the general property tax as applied to timber, a special Senate Committee investigating reforestation in 1924 declared: "A tax paid annually on growing forests which yield no income for 30 or 40 years is equivalent to the taxation of farm land with its growing crops 30 or 40 times between seeding and harvest. Such taxes not only consume a large part of the possible returns but compel the grower of timber to advance them long before they are realized. Unless extremely moderate, the yearly taxation of growing forests may debar the investment of funds in such enterprises."

It is felt by tax specialists that the method of taxing natural resources at the time of production, or severance, and in proportion to the amount or value of the product, is highly superior to the method of levying annual property taxes on the estimated value of the total resources. In a study of *Taxation in Minnesota,* Roy G. Blakey declares: "The figures seem to indicate that some mine owners, or the lessees, have paid taxes for rather long periods on iron ore that never existed. We cannot be sure of this, however, until the mines in question have been exhausted. It seems also that some mine owners or lessees have escaped paying taxes on large tonnages as a result of an underestimate of tonnage."

A tax on resources levied at the time of yield obviates the difficulties and inaccuracies involved in assessing the property. Moreover, it has no tendency to force uneconomic and socially wasteful utilization of resources, as is the case for example when the burden of paying annual taxes forces the cutting of timber prematurely or the unneeded development of other resources.

A further argument has been ad-

vanced for severance taxes. The natural resources are the heritage of the state. When this patrimony is used up the state should share in the profits therefrom and should utilize them for developing other economic resources to the end that the state's economic position may not be impaired.

The Assessment and Taxation Commission to the Constitutional Convention in Louisiana declared in its 1931 Report: "The Commission has endeavored to confine itself to recommendations which are calculated to bring about a more equal distribution of the burden of taxation, and has not undertaken to suggest, to any considerable degree, the manner of apportionment of the State's revenue among its several institutions and activities; but owing to the public nature of the severance or production tax, and in view of the fact that this tax can be collected only but once from the same source or commodity, and considering that the production from which the tax is derived necessarily depletes the natural wealth and capital assets of the State, we think it would be well for the Legislature to adopt the policy of reinvesting the revenue, thus derived, in something of a substantial and permanent character; thereby giving back to the public for the enjoyment of future generations, as well as the present one, in so far as is possible, compensation for that which has been destroyed and consumed, and which in no other wise can be replaced."

In a study of *Severance Taxation in Louisiana*,[1] by T. N. Farris, the following conclusion is reached in this respect: "It seems to be clearly demonstrated that the state's natural resources are being depleted and that no comprehensive, definite and continuing plan or policy has been adopted to assure a permanent and satisfactory patrimony from the severance revenues. . . .

"The conservationists might recommend the marginal and submarginal lands of Louisiana as eligible claimants for a considerable portion of severance revenues. These lands, properly administered, would be expected to prevent soil erosion, serve for recreational advantages, assume some importance as revenue producers, and enable the state of Louisiana to remove the stranded and ill-provisioned population to more advantageous localities and occupations."

Another reason for severance taxation, according to the National Resources Board,[2] is that "so many of the large mineral properties are in absentee ownership. The taxation trend reflects in some cases an indirect effort to reacquire natural wealth which has passed into private ownership."

1 Louisiana State University Press, 1938.
2 Report in 1934.

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HENRY GEORGE

Significant Paragraphs from Progress and Poverty *on the Single Tax on Land*

IT HAS long been contended that land and capital have substantially different economic characteristics and that the former is especially suitable for taxation. For many years this view has been associated with Henry George, whose principal work on this subject was entitled *Progress and Poverty*. Some paragraphs from this work follow: *

A house and the lot on which it stands are alike property, as being the subject of ownership, and are alike classed by the lawyers as real estate. Yet in nature and relations they differ widely. The one is produced by human labor and belongs to the class in political economy styled wealth. The other is a part of nature, and belongs to the class in political economy styled land.

The essential character of the one class of things is that they embody labor, are brought into being by human exertion, their existence or non-existence, their increase or diminution, depending on man. The essential character of the other class of things is that they do not embody labor, and exist irrespective of human exertion and irrespective of man; they are the field or environment in which man finds himself; the storehouse from which his needs must be supplied, the raw material upon which, and the forces with which alone his labor can act.

The moment this distinction is realized, that moment is it seen that the sanction which natural justice gives to one species of property is denied to the other.

For as labor cannot produce without the use of land, the denial of the equal right to the use of land is necessarily the denial of the right of labor to its own produce. If one man can command the land upon which others must labor, he can appropriate the produce of their labor as the price of his permission to labor. The fundamental law of nature, that her enjoyment by man shall be consequent upon his exertion, is thus violated. The one receives without producing; the others produce without receiving. The one is unjustly enriched; the others are robbed.

* * * *

Consider what rent is. It does not arise spontaneously from land; it is due to nothing that the land owners have done. It represents a *value created by the whole community.*

* Selected and compiled by Harry Gunnison Brown (New York: Doubleday, Doran & Co., 1928), pp. 36, 38, 46–47, 73. Reprinted by permission from Mrs. Anna George de Mille.

Let the land holders have, if you please, all that the possession of the land would give them in the absence of the rest of the community. But rent, the creation of the whole community, necessarily belongs to the whole community.†

* * * *

To abolish the taxation which, acting and reacting, now hampers every wheel of exchange and presses upon every form of industry, would be like removing an immense weight from a powerful spring. Imbued with fresh energy, production would start into new life, and trade would receive a stimulus which would be felt to the remotest arteries. The present method of taxation operates upon exchange like artificial deserts and mountains; it costs more to get goods through a custom house than it does to carry them around the world. It operates upon energy, and industry, and skill, and thrift, like a fine upon those qualities. If I have worked harder and built myself a good house while you have been contented to live in a hovel, the tax-gatherer now comes annually to make me pay a penalty for my energy and industry, by taxing me more than you. If I have saved while you wasted, I am mulct, while you are exempt. If a man build a ship we make him pay for his temerity, as though he had done an injury to the state: if a railroad be opened, down comes the tax-collector upon it, as though it were a public nuisance; if a manufactory be erected we levy upon it an annual sum which would go far toward making a handsome profit. We say we want capital, but if any one accumulate it, or bring it among us, we charge him for it as though we were giving him a privilege.‡ We punish with a tax the man who covers barren fields with ripening grain; we find him who puts up machinery, and him who drains a swamp. How heavily these taxes bur-

† To the view of the extreme conservative that due consideration for the claims of rent receivers negatives the adoption of such a policy, it may be replied that society as such is under no obligation to maintain an unchanged policy throughout all future time. Public policies are constantly changing in such ways as to disappoint the expectations of persons who have invested on the supposition that policies would not change and to affect the value of their property. Tariffs are raised, and lowered. The brewing of spirituous liquors is at one time permitted and at another time outlawed. Prices of monopolized services are first left to be fixed by the monopolists and are then regulated. Taxes are increased on some goods and decreased on others. In some communities taxes have already been made higher on land values than on improvements. Purchasers of land have no right to insist that society may not, even by gradual steps, discriminate in taxation against land rent, which is an income *socially produced.* (Henry George himself elsewhere said—*Century Magazine,* July, 1890—that "we cannot get to the Single Tax at one leap, but only by gradual steps.") We must presume that land owners, like other persons, buy their property with no guarantee that public policy will never change. The conservative insistence that society, which makes frequent changes of policy in other matters, is under a binding implied pledge and obligation never to move, even by successive steps, towards the eventual taking of the economic rent of land by taxation, seems preposterous. [H. G. B.]

‡ The present system penalizes efficiency and thrift, exactly what conservative supporters of the existing system criticize *communism* for doing. In his endeavor to block bare-land-value taxation, which is individualistic, which would not penalize any future industry or thrift of any person, how far will the defender of the present system adopt the philosophy of *communism* and of *socialism!* In those respects in which communism and socialism are most to be criticized, the *ultra-conservative is far more a communist or a socialist than is the "single taxer."* [H. G. B.]

den production only those realize who have attempted to follow our system of taxation through its ramifications, for, as I have before said, the heaviest part of taxation is that which falls in increased prices.

To abolish these taxes would be to lift the whole enormous weight of taxation from productive industry. All would be free to make or to save, to buy or to sell, unfined by taxes, unannoyed by the tax-gatherer. Instead of saying to the producer, as it does now, "The more you add to the general wealth the more shall you be taxed!" the state would say to the producer, "Be as industrious, as thrifty, as enterprising as you choose, you shall have your full reward! You shall not be fined for making two blades of grass grow where one grew before; you shall not be taxed for adding to the aggregate wealth."

* * * *

The truth that I have tried to make clear will not find easy acceptance. If that could be, it would have been accepted long ago. If that could be, it would never have been obscured. But it will find friends—those who will toil for it; suffer for it; if need be, die for it. This is the power of Truth.

Will it at length prevail? Ultimately, yes. But in our own times, or in times of which any memory of us remains, who shall say?

For the man who, seeing the want and misery, the ignorance and brutishness caused by unjust social institutions, sets himself, in so far as he has strength, to right them, there is disappointment and bitterness. So it has been of old time. So is it even now. But the bitterest thought—and it sometimes comes to the best and bravest—is that of the hopelessness of the effort, the futility of the sacrifice. To how few of those who sow the seed is it given to see it grow, or even with certainty to know that it will grow.

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E.R.A. SELIGMAN

The Single Tax

MANY of Henry George's views were unacceptable to Professor E. R. A. Seligman, who criticized them, in part, as follows: *

The result of this consideration is that a tax on land values is legitimate because it reaches one of the elements of taxable ability. But the conclusion follows with equal force that the demand for a single tax on

* From *Essays in Taxation,* pp. 74, 80–83, 96–97. By permission of The Macmillan Company, publishers.

land values is inadmissible. This is true for two reasons: in the first place it emphasizes the principle of privilege to the neglect of all the other constituent elements of faculty; it attempts to erect into the superior position a point of inferior importance; it takes a part and makes of it a whole. In the second place, even if the principle of privilege were put into this position of pre-eminence, the single-taxers err in singling out a particular privilege and basing their system on this, to the exclusion of other scarcely less important privileges. This point will be more fully discussed below, under the head of the justice of the single tax. Thus in a double way the single-taxers have failed to gain the assent of tax scientists and tax reformers. The arguments, which are of unquestioned validity when advanced in favor of the addition of a land-value tax to existing fiscal systems, lose their force in proportion that the emphasis is laid on the desirability of the single tax.

* * * *

Land values do not always or necessarily increase. Thus, in the testimony given before the Rapid Transit Commission in the city of New York in March, 1895, one of the witnesses spoke of several long avenues being lined with the graves of property-owners. What did he mean? Simply that ten, or twenty, or thirty years before, certain individuals had invested in the land, in hope of a rise in value, just as people invest in bonds or stocks or other securities. Instead of values rising, however, they remained stationary or even decreased; while, in the meantime, the accumulated taxes and assessments upon this nonproductive property completely ruined many of the investors. It is indeed true that in most growing cities land values in certain localities will increase; but it is equally true that there are always sections in such cities where, for obvious reasons, land values decrease. These facts are familiar to all observers in large cities. Moreover, in some European countries the rental value of the land, in whole sections, is less to-day, owing to transatlantic competition, than it was a few decades ago. The tax on land value would in such cases yield only a precarious revenue.

More important still is the fact that even though land values often increase, similar increase in value is not by any means confined to land. Let us ask anyone whose mind is not befogged by the mist of erroneous enthusiasms; Who are the rich men of the world to-day? How has by far the greater part of our huge individual fortunes been acquired? Let us study the way in which men have become millionaires, especially in the United States. The usual cause is some fortuitous conjuncture of events, some chance happening due to no one's labor, but to a turn in the wheel of fortune—call it speculation, call it luck, call it by any name we will. How have most of the fortunes in Wall Street been made? Who is responsible for the increased value of investments? Who can say that the successful manager of the ring, the corner, the pool and the trust has worked out his salvation through his own industry? Land speculation is only a part of the sum total. If it be claimed that the fortunate speculator deserves his fortune because of his sagacity and foresight, why deny these attributes, at least in part, to the landowner? It can, of course, not be denied that

wealth has been acquired by thrift and industry; but it remains true that most of the very large fortunes that strike the common observer are due to these incalculable turns in the wheel of fortune, and that the so-called unearned increment of land values forms only a portion of these total gains.

Value is a social, not an individual phenomenon. If social environment gives a value to bare land, the same social environment, by increasing the demand for other commodities, may at least in part help to augment their value. It is indeed true that if we contrast land with concrete commodities that can be multiplied at will, the difference seems to be profound. Increased demand may lower, not increase, the price of the latter, by reducing cost of production. But what the single-taxers forget is that property consists of, and income is derived from, not only concrete commodities, but services, relations and privileges of all kinds,[1] where increased demand, outstripping any corresponding decrease in the cost per unit of producing a greater supply, is primarily responsible for the increased value. A newspaper in a desert is worth nothing; a newspaper in a town is worth something; a newspaper in a city is worth still more. The newspaper is in part the product of labor, but the greater demand increases the value. A milk-route also is more profitable in a city than in a village. If it be said that land differs from all these in that it is a monopoly, the answer is irresistible that if there is any one thing which distinguishes the modern age, it is the development of economic monopolies of all kinds. So important, indeed, have these become that modern economic theory has been compelled to supplement the old doctrine of value which was based on the assumption of free competition by a newer and more comprehensive theory, especially applicable to all these modern forms of monopoly price. Many of these monopoly profits cannot be reached by a tax on land values.

On what possible theory of justice, then, shall we tax the man who has invested $100,000 in land which the next year appreciates fifty per cent; and, on the other hand, exempt the man who has invested $100,000 in the stock of the Sugar Trust, which the next year may also enhance fifty per cent? Why should the earnings invested in land be taxed and the earnings invested in any corporate security be wholly untaxed?

It might, indeed, be claimed that a railway stockholder will be affected by a tax on the land owned by the corporation: but it is difficult to see how a railway bondholder can be reached by any tax on land values except in so far as the ultimate security for his debt may be affected. As the bonded indebtedness of the railways to-day far exceeds their capital stock, it appears that, even in the case of these industries whose increasing values are largely due to the influence of the community, the majority of investors would scarcely be touched. In the great mass of industries, of which the Sugar Trust is an example, where the land owned by the corporation is of exceedingly small consequence as compared with its other assets, it is plain that a tax on land values would not reach even the stockholders or the owners proper. Almost every industry, more-

[1] Seligman, Principles of Economics (*9th ed.;* Longmans, Green & Company, 1921), Secs. 84, 113.

over, is dependent for its increasing profits upon the development of the community, that is, upon the increasing demand for the product. Land rises in value because there are more people who want to occupy that land; the earnings of a city newspaper increase chiefly because there are more people who want news. In each case the increased returns are due primarily to social causes; and while a larger newspaper indeed costs more to produce, while more land does not, yet so far as actual profits are concerned, the distinction between them, for all practical purposes, is one only of degree, not of kind. To confiscate the capital invested in land with the chance of the land either falling or rising in value, while exempting absolutely the capital invested in corporate or industrial securities, is but a travesty of justice. It will be impossible to convince the common people that so-called unearned increments are confined to land. As a matter of fact the "unearned increment" of land is only one instance of a far larger class.

So far as a man receives special opportunities from the community, which undoubtedly increase his ability to pay, they should be taken into account in framing any scheme of taxation. And since the rapid growth of modern towns brings into strong relief the appreciation of site values which are due primarily to the growth of the community itself, it is not only justifiable but eminently desirable that a part—and a large part—of the revenues should be raised from a tax on land values. But let us not single out one special opportunity, because it strikes the eyes of urban observers, while we neglect all the other opportunities which are equally, or almost equally, the result of social forces. While some kind of a tax on land values is a legitimate part of a tax system, the single tax on land values is unjust; first, because opportunity is not the only element that must be taken into account in framing a tax system; and, secondly, because, even though it were, revenues from land are by no means the only form of the results of special opportunity. The single tax is unjust because it is exclusive and unequal.

Even though the single tax, however, were theoretically just, it would not follow that it is desirable. Let us, therefore, come to the final part of our inquiry.

* * * *

IV. Conclusions

We have studied the single tax from different points of view. It is undoubtedly true that the single-tax agitation has been of great value. It has in some countries served to direct attention to the abuses of a mediaeval land system. It has in the United States helped to disclose the shortcomings of the antiquated general property tax. It has everywhere done yeoman's service in emphasizing the question of unjust privilege. But none the less we have found ourselves unable to accept its demands. We have seen that the single tax is defective fiscally, politically, morally and economically. We have learned, first, that it would be inelastic, and that it would intensify the inequalities resulting from unjust assessments; secondly, that although itself proposed chiefly from social considerations it would prevent the government from utilizing the taxing power for other social purposes, and that it would divorce the interests of

the people from those of the government; thirdly, that it would offend against the canons of universality and equality of taxation, and that it would seriously exaggerate the difference between profits from land and profits from other sources; and finally, that it would be entirely inadequate in poor communities, that it would generally have an injurious influence on the farmer, and that even in the large urban centres it would exempt large sections of the population without bringing any substantial relief to the poorer classes.

This is clearly not the place to discuss the wider claim of the single-taxers, that the application of their scheme would introduce the social millennium. Even as a method of tax reform, however, the project is, as we have seen, a mistaken one. Our system of taxation is far from being ideal, or even comparatively just. But whatever be the much needed reform and however desirable may be the addition of a tax on land values to existing revenue systems, it is not probable that either the common people or the student will accept a scheme which is at bottom palpably unjust, which abandons one of the fundamental theories of modern taxation—that of relative ability or faculty—and which seeks to put the burdens of the many on the shoulders of the few.

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JAMES H. GILBERT

Land Taxation in New Zealand

AUSTRALIA and New Zealand are generally recognized as the countries that have given widest application to the Georgian approach to taxation. The experience of the latter country with local taxation of unimproved land values is described in the following selection.* In addition to the local tax, here considered, both Australia and New Zealand have a graduated tax on holdings of land by any one owner above a specific exemption. Both countries also hold land in public ownership, subject to long-term lease to private operators, on a much larger scale than elsewhere.

* Reprinted by permission from James H. Gilbert, *The Tax Systems of Australasia* (Eugene: University of Oregon, 1943), pp. 151–153; 165–166.

This study has, up to this point, been primarily concerned with dominion systems, with only incidental references to local taxation. In the consideration of the Australian tariff system it became necessary, however, to trace the history of customs duties in force in several states as a means of understanding the uniform customs act of 1901. In the treatment, too, of the Australian land tax it was found desirable to relate the history of state systems in force before 1910 and the economic philosophy that lay back of them. Because of the intimate connection between the New Zealand land tax and the system of local rating on unimproved value, it seems desirable to devote a chapter to local rates in the Dominion.

The system of rating on unimproved value, made optional with local bodies under the colonial act of 1896, approaches more clearly in theory and practice to the single-tax program than does the Dominion land tax. As indicated already, the adoption of rating on unimproved value is optional with ratepayers in the locality; unless this system is specifically authorized by vote of the property owners, one of two traditional systems continues in effect, namely, rating on annual value or on capital value.

The latter of these two systems does not differ materially from our American property tax, which has degenerated or evolved into a tax on real estate. The former system, based on income or rental value of real estate, presents some features of novel interest to American students of taxation. Although rating on annual value is common in all British countries, it is practically unknown in the United States.

It should be noted at the outset that local taxes in New Zealand are far less important than in America. As explained elsewhere, the government of New Zealand is much more highly centralized than is the case in American commonwealths. Local governments in the United States raise by taxation almost exactly three times as much as the states, and approximately the same amount as the national government before the program of national defense compelled sweeping increases in federal taxes. In contrast, New Zealand local governments in 1937 collected £6,624,000 by taxation, or about one-fifth as much as was gathered in for Dominion purposes.

Local governments rely almost entirely on rates levied on real estate to meet all obligations. Three classes of local rates are recognized, depending on the purpose for which the expenditure is made. There are general rates for the discharge of ordinary and traditional functions, special rates for the construction of public works, and special rates for the payment of public debts. As stated above, these rates, whether general or special, may be levied on one of three bases: (1) on capital value, (2) on annual value, or, where the community by a vote of ratepayers exercises the option, (3) on unimproved value. In rare cases, especially in country districts, acreage may be the basis of the levy; special rates levied for rabbit control are often on the basis of number of sheep or cattle owned.[1]

Annual value is calculated as letting or leasing value less 20 per cent in the case of houses and perishable property (evidently an allowance for insurance and depreciation) and less

[1] *Year Book*, 1940, p. 656.

10 per cent in the case of land. In no case, as the law specifies, is the annual rateable value to be less than 5 per cent of the value in fee simple.

It must not be assumed that all *revenues* in New Zealand communities are from taxes. Licenses and permits of various kind supplement regular taxes to some extent; and more than £3,000,000 annually accrues as earnings from commercial enterprises, examples of which are electric lighting and power, tramways and busses, and gas works. Waterworks, although publicly owned, do not contribute to commercial revenues, since the cost of water service is assessed on real estate in the form of rates.[2]

Counties and boroughs are the principal rating authorities; but, as in America, various districts are formed for rating purposes to defray expenses of specialized service. There are electric-utility districts, drainage districts, flood-control districts, and rabbit districts to control the spread of rabbit pests. Local authorities may adopt any basis for rating without submitting to a referendum, except where a change to rating on unimproved value is contemplated. In this case a petition from ratepayers, followed by an election, is necessary. In case the locality levies its local taxes on capital or on unimproved value, the assessment rolls are made up, not by local authorities, but in the central office of the valuer general. It will be recalled that local bodies were expected to contribute to the expense of the Valuation Department and in return were entitled to receive assessment rolls complete and ready for use. Valuations on individual properties are revised in response to information received, transfer data, or first-hand estimates made by valuers in the field. These revised estimates are segregated according to the district to which property belongs, and at the appropriate time the revised rolls are forwarded to local authorities.

At this point a contrast should be drawn between assessment practices in American states and those of New Zealand. In America where the state governments still rely on property taxes for a part of their necessary revenues, assessments are, with few exceptions, made up by local elective officers subject only to general supervision of central authorities such as the tax commissions. This practice lacks uniformity. And assessors, subjected to varying degrees of pressure, underassess property at widely different percentages of true cash value. Even with the best efforts at equalization, a general levy by the state may involve inequalities between minor subdivisions. In New Zealand the whole process is highly centralized.

* * * *

Here again one is prompted to enter the caution that both advocates and critics of the New Zealand system are inclined to exaggerate the economic effects of rating on unimproved value, even where all rates are upon land value alone. As indicated elsewhere, local taxes are mild when compared with the levy in a typical American city. If the whole burden of local taxation in such an American city were thrown upon site value alone, the rate would rise to alarming proportions. In Wellington, capital city of New Zealand, where local rating is upon unimproved value and the tax covers the cost of water service in addition to

[2] *Ibid.*, p. 660.

general functions, the ruling rate has been around 8*d.* in the pound, the equivalent of 33 mills in terms of American tax notation. This is the equivalent of a 66-mill tax on a 50 per cent valuation—pretty close to the ruling rate in American cities. It should be kept in mind that the Wellington rate applies to site value alone, while the American rate would apply to buildings and improvements and tangible personal property. If Wellington rated on capital value, following the practice of American cities, the rate would be 3.4*d.* in the pound, or 14.3 mills. The shifting of so mild a rate from one basis of levy to another can scarcely be responsible for any far-reaching economic consequences.

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E.R.A. SELIGMAN

The Classification of Public Revenues

IN THE following selection,* Professor E. R. A. Seligman introduces the ways and means other than taxation by which a state may raise revenue and discusses these ways and means in terms of the fundamental sovereign powers which are exercised in each case.

Among the unsettled questions of the science of finance few are more troublesome than that of classifying the different kinds of public income. Classification is indeed not of supreme importance, for matter is always more essential than form. But correct classification is helpful in many ways. It requires logical criticism and rigorous analysis, and thus becomes a test of mental vigor; it conduces to accurate definition and prevents looseness of expression and confusion of thought; it may have important practical results in deciding questions of fact and in assigning definite values to doubtful categories; it points out contrasts and resemblances, and by eliminating or combining what is common, often suggests a clearer conception of the subject-matter. Correct classification is, in truth, an essential condition of all scientific progress.

It has frequently been remarked that we must distinguish between historical and actual classifications. For example, the whole class of lucrative prerogatives—the *Regalia* of the Teutonic kingdoms and of early fiscal science—were formerly separated from the other categories of

* From *Essays in Taxation,* pp. 399–406. By permission of The Macmillan Company, publishers.

public revenues because of their commanding importance in medieval countries and of their supposed points of difference; whereas well-nigh every recent writer of importance, even in Germany, has confessed that all such revenues are capable of being classified under one of the other modern categories. So, again, while the revenue from the incidents of feudal tenure played a great rôle in the classification of Blackstone and other early writers, the need of showing the composite nature of such revenues has been obviated by the disappearance of the tenures themselves. Finally, special assessments are a growth of comparatively recent times. Only a short time ago, a classification of public revenues might safely have ignored their existence; now a logical classification of actual revenues would be incomplete without them. What concerns us here is a classification applicable to modern conditions.

I. *The Primary Classification*

From the standpoint of the individual all contributions to government are either gratuitous, contractual or compulsory. Every governmental revenue must fall within one of these three great classes. Individuals may make the government a free gift, they may agree or contract to pay, or they may be compelled to pay. The first method of securing revenue was at one time important, but its influence to-day is slight. The second and third methods correspond to the widely adopted classification suggested by Adam Smith,[1] who tells us that:

> The revenue which must defray . . . the necessary expenses of government may be drawn either, first, from some fund which peculiarly belongs to the sovereign or commonwealth, and which is independent of the revenue of the people, or, secondly, from the revenue of the people.

That is, the government may in the first place act like a private individual, possessing lands or other revenue-yielding property, and engaging in mercantile, financial or industrial pursuits. As Petty, the author of the first systematic English treatise on taxation, put it in the seventeenth century, the state is in some places the common cashier, the common usurer, the common insurer or the common beggar.[2] This is what the French call in the widest sense the revenue from the private and industrial domain of the state, and what the Germans term the private-economic income. A better term, perhaps, is contractual income; since the government here puts itself in the position of a private person making a contract with another person. Such payments all rest on an agreement between the two contracting parties, in sharp contrast to the payments which the government demands by virtue of the sovereign powers delegated to it.

We often hear of the distinction between voluntary and compulsory contributions, meaning by the former the free gifts of the citizens. This distinction, however, is not perfectly accurate; for contractual contributions are also voluntary, without being gifts. In the case of a contract, the government agrees to do some particular thing in return for a payment, leasing land, for instance, in return for rent; in the case of the free gift, the government does not

[1] *Wealth of Nations*, Book V, Chap. 2.

[2] William Petty, *A Treatise of Taxes and Contributions* (London, 1667), pp. 60, 61.

undertake, nor does the donor expect, any specific action in return. Yet both payments are voluntary. We must therefore distinguish not merely between voluntary and compulsory contributions, but between gratuitous, contractual and compulsory contributions.

Thus far almost all writers are agreed. The difficulty arises when we desire to classify the various kinds of compulsory revenues and to distinguish between some of these subdivisions and the different kinds of contractual revenues. All possible combinations have been made, especially by recent German writers. Let us confine ourselves in this chapter to the pith of the controversy, namely, to the subdivision of the compulsory contributions and their relation to some of the contractual revenues, as, for instance, the charges made for the services of governmental enterprises, like the postoffice, the telegraph and the like.

In taking the property of individuals the sovereignty of the modern state manifests itself in different ways. The government may exercise in turn the power of eminent domain, the penal power, the police power or the taxing power.

The power of eminent domain confers on the government the right of taking at its discretion, and to an indefinite extent, private property for particular uses. With the constitutional and moral limitations upon this power we have not here to deal, chiefly because the power is for the most part not a source of net revenue. The fact that in all free governments private property cannot be taken under this power except for public use, and even then not without just compensation, would in itself show that no net income to the state is contemplated. Yet such revenue may accrue incidentally; for the benefits accruing to the government through the expropriation may conceivably be greater than the damage inflicted on the private individual. Revenue through expropriation is thus the first class of compulsory income.

The second sovereign power of fiscal importance is the penal power, or right of inflicting fines and penalties, known technically as the power of sanction. This might be declared a part of the police, or regulative, power of the state, since every government regulation must carry with it the power of enforcement. But on account of the decidedly problematic fiscal importance of the police power, it seems better to separate them. The power to adjudge fines and penalties, however, while often quite important as a source of revenue, belongs rather to penology and administration than to the science of finance; for the private property is here taken, not in accordance with the needs of the state or with any principles of equality of uniformity or benefits or compensation, but solely as a punishment inflicted on the individual. The only limit to its fiscal significance in free countries is the vague provision, as in the constitution of the United States, that excessive fines shall not be imposed or cruel and unusual punishments inflicted. Fines and penalties thus form by themselves a class of compulsory revenues levied according to definite but non-fiscal principles. It is obviously wrong to class them with fees, as do some writers, or to ignore them entirely, as do others.

The third sovereign power of the state is the police power, or the power of regulation. This has played

a great rôle in American jurisprudence. Yet it may be confidently stated that from the standpoint of the science of finance the distinction drawn between the police power and the taxing power is to a great extent a fiction, referable to certain difficulties in American constitutional law and to a lack of economic analysis on the part of the judges. Let us study this point more in detail.

II. *The Police Power versus the Taxing Power*

The commonly accepted distinction between these powers is that the former is for regulation and the latter for revenue. One argument in support of this view is that advanced by authors like Mr. David A. Wells, who contend that a so-called tax which looks to anything besides the securing of revenue is not a tax, but an unconstitutional exercise of the taxing power. But even adherents to the distinction between the police power and the taxing power, like Judge Cooley, confess "that, in the apportionment of taxes, other considerations than those which regard the production of a revenue are admissible, and that the right of any sovereignty to look beyond the immediate purpose to the general effect cannot be disputed."[3] The position of Mr. Wells is the exact opposite of that of Professor Wagner, who includes in the very definition of a tax the "socio-political" element or the duty of regulating and correcting the distribution and use of private property.[4]

The one writer would refuse the name "tax" to an imposition looking to anything else than mere revenue: the other ought logically to withhold the name from an imposition *not* looking to anything else than mere revenue. These positions are mutually exclusive and equally extreme.

On the other hand, the distinction of Judge Cooley is almost quite as untenable. Cases where the primary purpose is regulation, he thinks, are referable to the police power; cases where the primary purpose is revenue are referable to the taxing power. Mr. Cooley himself confesses that import duties with incidental protection are taxes. But suppose, as has often occurred, that they are protective duties with incidental revenue. Are they any the less taxes on that account? How about the tax on bachelors, which was imposed for the express purpose of diminishing celibacy? How about the ten per cent tax on state bank notes, imposed avowedly to destroy the state bank issues? How about the American tax on oleomargarine, confessedly of a regulative nature? How about taxes on spirituous liquors in the shape of liquor licenses, to regulate and diminish the liquor traffic? How about the many indirect taxes enacted in consequence of sumptuary laws? How about certain inheritance taxes, whose imposition is demanded on the express ground that they will limit fortunes? How about the single tax, whose only *raison d'être* is the attempt to change the existing distribution of wealth? Shall we call the Indian duty on opium a tax, and refuse the name to the American internal revenue charge, because India looks primarily to revenue, and the United States to regulation? Shall we call the French *impôt des patentes* a tax, and deny the name to the analogous license or

[3] Cooley, *Taxation* (2d ed.) p. 587.

[4] Wagner, *Finanzwissenschaft*, ii. (2d ed.; 1890), p. 210.

privilege taxes in some of the Southern commonwealths, because in the latter case the object is sometimes distinctively regulative? In fact, if this is to be our line of cleavage, we must reconstruct the science of finance and remove from the class of taxes whole categories of impositions to which no one has ever thought of denying the character or name of tax.

The confusion in the American law is at once complimentary and uncomplimentary to the judiciary. It is complimentary in the sense that the judges, when brought face to face with the conflict between constitutional limitations and the demands of social evolution (or what is known in legal parlance as public policy), have sought to remain true to their function as the final interpreters of social progress. This they have been able to do, however, only through legal fictions and divergent decisions. Anyone who has studied the American law of taxation as a whole must have become painfully conscious of the hopeless contradictions among the laws of the several states on many important points. This condition is due in great measure to the fact that the constitution or laws of one state by implication forbid what the constitution or laws of another state expressly permit. In order to take an actual case, which is perhaps in line with public policy, out of the range of the legal inhibition, the courts of the first state are forced to adopt an interpretation wholly unnecessary in the second. Thus the continuity of social development is preserved, even at the sacrifice of legal consistency or uniformity. For instance, in New York street-car licenses are held to fall under the taxing power, while in Pennsylvania they are put under the police power, simply because, under the particular conditions, it seemed to be a matter of equity, in the one case to uphold, and in the other to object to, such a charge.[5] The payment in the two instances was the same, both in amount and in principle; but the attempt to make the same laws conform to a public policy which differs in the different states has brought about a contradiction. So, too, the whole system of high license or liquor taxes is in some states brought under the taxing power; but in others, because of certain constitutional difficulties, it is put under the police power.[6] To this extent the police power has been a legal fiction to enable the courts to uphold what could not well be brought under the taxing power; although in another leading case [7] the liquor tax was upheld under the taxing power because there was a constitutional obstacle to its being put under the licensing or police power. The police power is of great and growing legal importance in the United States, largely because of the peculiar principles of American governmental relations, whereby local bodies are deemed to have only those powers expressly delegated to them, in contradistinction to the European method according to which local bodies possess, in certain respects, all powers not expressly withheld from them.[8] Many of our cities and towns

[5] Cf. 2d Avenue Railroad Cases, 32 N.Y. 261, with Railroad Company *vs.* Philadelphia, 58 Pa. 119. What was held "reasonable" in one case was declared "unreasonable" in the other.

[6] Burch *vs.* Savannah, 42 Ga. 596. Cf. 50 Texas, 86.

[7] Youngblood *vs.* Sexton, 32 Mich. 406.

[8] Goodnow, "Powers of Municipalities Respecting Public Works," *Publications of the American Economic Association,* II, pp. 72–79. Professor Goodnow terms these re-

have no taxing power; and even when they have the power, it is strictly construed. The courts, therefore, have been compelled to uphold much under the police power that under other and more favorable conditions they would and could have upheld under the taxing power.

On the other hand, there is an element which is not quite so complimentary to the judges. The courts have frequently confused taxes in the narrower sense with the exercise of the taxing power in the wider sense. As we shall see, there are various forms in which the taxing power may manifest itself: taxes in the narrower sense are only one form. Special assessments for instance, have been almost universally upheld as an exercise of the taxing power, while sharply distinguished from taxes in the narrower sense. Yet in a leading case sidewalk assessments, which as a matter of principle do not differ at all from other special assessments upheld under the taxing power, have been declared police regulations.[9] The court has here simply confused taxes with the taxing power. It is, moreover, impossible to see any difference between the various cases of sewer and levee assessments quoted by Mr. Cooley as an exercise of the police power and the cases of sewer and levee assessments quoted by him in another chapter as falling under the taxing power.[10] The whole distinction, in fact, rests upon a confusion. So, again, while both taxes and fees are an exercise of the taxing power, because it has frequently been deemed necessary to uphold license fees by distinguishing them from taxes, many of the courts have declared license fees to be an exercise not of the taxing power but of police power, thus confusing taxes with the taxing power. There is, as we shall see, a decided difference between a license fee and a tax; but it is not the one stated by the courts. It is this groping after the real distinction between fees and taxes, to be explained in a moment, which has led judges, not trained in economics, to draw the line between payments under the police power and those under the taxing power. The distinction between fees and taxes is not synonymous with the distinction between the police power and the taxing power; for there are many classes of fees, like court fees, fees for legal documents and school fees, which cannot possibly be put under the police power.

While, then, it may be expedient from the legal point of view to distinguish between the police power and the taxing power, ruling that the one is for regulation and the other for revenue, and while the constitutional importance of the police power, especially in the United States, is in many respects considerable, the distinction from the economic and fiscal standpoint is, nevertheless, wholly unnecessary. A tax is no less a tax because its purpose is regulation or destruction; and a fee or payment for regulation brings in just as much revenue as a precisely identical fee imposed primarily for revenue. From the standpoint of finance the test is not whether the payment is for regulation, but, as we shall see later, whether it is primarily for special benefit or primarily for common benefit; that is, it is a

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spectively the systems of legislative and of administrative control.

[9] Godard, Petitioner, 16 Pick. 504, 509, quoted by Cooley, *Taxation*, p. 589.

[10] Cooley, *Taxation*, pp. 588–591, compared with pp. 616–620.

distinction not between police power and taxing power, but between fees and taxes. In other words, payments that are legally put under the police power ought scientifically to be classed under the taxing power.

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NATIONAL TAX ASSOCIATION

Discussion of Municipal Utility Earnings as a Source of Municipal Revenue

AS SUGGESTED in the last selection, the state is by no means confined to taxes in its search for revenues. Among other available means, it may assume the role of an entrepreneur and apply the profits from public enterprises to its needs. The financial aspects of public ownership of public utilities were recently discussed at a conference of the National Tax Association. The informal discussion, following a more formal program, is here reproduced: *

CHAIRMAN CHATTERS: Thank you, Professor Cottrell.

You heard from Professor Hall's excellent paper the definition of what service at cost is. You have heard from the five people who have told us how service is furnished at more than cost, so that part of the money can be taken to finance general activities.

We still have the question, I suppose, of whether or not that is always desirable. We have asked Mr. Charles J. Fox, the city auditor of Boston, Massachusetts, to open the discussion and present the issues to you.

CHARLES J. FOX: Mr. Chairman, Ladies and Gentlemen: I suppose in opening the discussion I might be expected to give you a dissertation on the subject from all angles, but if I attempted to do that it would be a case of a fool rushing in where an angel would fear to tread, because back in the old Bay State this problem which is before you this morning does not receive much consideration because we have very few public or municipal utilities.

In my home city of Boston, we have a water department, but the water is furnished to us by a metropolitan district commission—in other words, we simply receive the water at our city boundaries and distribute

* *1939 Proceedings,* National Tax Association, pp. 521–526.

it. Under the statute law, if we have a profit at the end of any year, that profit must be used, first, to reduce any outstanding water debt, and after that is done, any debt of the city.

So that from the taxpayer's point of view, very little relief is secured in Boston, and in general throughout Massachusetts, from the utilization of municipal utility profits.

Here we have a definite proposition, a proposition of great moment. We have had six excellent presentations, and I think there is enough meat in those presentations to discuss them and nothing else.

In the beginning, we had a definition of cost by Professor Hall, in which he admitted certain items as beyond question entering into cost, the cost analysis, and other items which he questioned.

From a municipal point of view, there might be disagreement on some of the items which Professor Hall questioned. If there is any disagreement, then I think in this discussion it should be expressed.

Then in the five practical papers giving experiences and what has been done, actual test cases, we have had all sections of the country represented.

In Michigan, we have seen that profits are used, first, for dividends; second, for contributions to general government; third, for projects which might not otherwise be taken care of; and, fourth, contribution of free service to the municipal family.

In Ames, Iowa, we saw that these transfers were used to maintain tax rates on practically a level—in other words, to offset the injurious effects of losses in assessed evaluations.

In Jacksonville, probably you were confused just as I was, because we got away from Michigan and Iowa, where they deal in dollars and cents, and we were up in the millions of dollars in Jacksonville—that is, we were in the big league.

But in looking over this paper, I see that the statement is made that if taxes had been paid by the municipal utilities, the return to the government would have been approximately $2,000,000; whereas it is estimated that the returns from all forms to the government, for municipal government under the practice in Jacksonville, has been roughly $13,800,000 in the last thirteen years. Then in Coffeyville, Kansas, twenty years ago Wilson was attached to the slogan, "He kept us out of war"; in 1939 he is attached to the slogan, "He kept us out of taxes."

Then there was Professor Cottrell's very excellent presentation in which he indicated elements of cost that are figured in Palo Alto, and he also showed by the chart the distribution of the surplus revenues.

With this material before us, I think the discussion should now proceed.

Simeon E. Leland (Illinois): I heard Mr. Wilson say that this tax-free city that he represented attracted a lot of industries.

Well, I would like to know how it is that when they charge people more than the cost of utility service, they can attract industries in such a place, well knowing that the cost of all municipal government is loaded into the utility rate; and if you do, in fact, attract, what kind of industries do you attract?

Chairman Chatters: Mr. Wilson, will you answer that?

Mr. Wilson: To answer that, I didn't mean that that was the only

attraction. I meant that reduced tax rates made a town more attractive to industries and to residents of all classes. We don't raise our light rate; we are lowering it all the time. We have a light rate that compares favourably with every other town in the state. There is only one city that has a lower rate, and that is Kansas City, Kansas. They operate on the theory of taxing the town and putting down the rate. They have one of the highest tax rates in the state, where we have the lowest rate of any first-class city in Kansas.

MR. LELAND: Do your utilities use any light?

MR. WILSON: In Kansas, we can't use the profits of our water utility for anything except the retirement of bonds and the extension of the plant. In some cases we can use some of it for fire department equipment, and that is all we can do with our water earnings under the law. Our profits that reduce our taxes are entirely from the light plant.

Our domestic rate for the first fifty KWH is five and a half cents, and for the next fifty it is three and a half; for the next hundred, two and a half, and for all over that, two cents. We have a combination rate for electric ranges; a three-dollar minimum, the first sixty KWH is five cents; the next forty is two and a half; the next 100, two; and all over that, one and a half. That makes a very attractive rate, and the increase in the use of electric appliances has been very rapid in Coffeyville. Our load is continually growing; our population is gradually increasing; and we are very well satisfied with the tax-free city.

MR. LELAND: I see that, but that doesn't answer the question.

What I was interested to know was if, in fact, your policy of paying the expenses of the town out of utility and other municipal industry profits attracts industries, as you implied, what kind of industries are being attracted—those that use utility service or those that don't?

MR. WILSON: The industries we have were not attracted by this low tax rate. All I meant in saying that was that naturally now in the last two years when we have eliminated the taxes it is an attraction.

We have a number of industries. We have a $5,000,000 annual payroll. We have two large oil refineries, a Sherwin-Williams smelting plant and a big roofing material factory. We have some big mills, and we have several oil well supply manufacturing concerns, for instance, the Oil Specialty Company which employs 600 men.

MR. LELAND: Are those industries large consumers of these utility services?

MR. WILSON: We sell power to nearly all of them, and we have a very low power rate.

VON T. ELLSWORTH (California): I wonder if I might ask some of these speakers, advocates of municipal ownership, to answer a question: How would you meet your responsibility to other or higher units of government, such as county or state?

Surely, the acquisition of the utility by a municipality, assuming it is tax exempt, would then deprive the county and the state of tax profits. How would you make that up, in fairness to other portions of the state?

CHAIRMAN CHATTERS: The question is this: If you have a municipal utility, which in itself is free from taxation, how do you make up to the state or superior unit of government

the taxes which that utility would pay?

MR. ELLSWORTH: Yes. For example, in Coffeyville I understood that they even extended their electric projects through PWA funds. Supposing we accepted the invitation of this hospitable gentleman from Kansas and went to Coffeyvlle—economically, where would the PWA funds come from?

CHAIRMAN CHATTERS: I don't think your question is clear. I don't think what you said last is the question you asked in the first place.

Is this your question? If you have a municipal utility which is tax exempt, how are you meeting what would otherwise be the charge and the taxes paid to the state or superior government? Is that your question?

MR. ELLSWORTH: Yes.

CHAIRMAN CHATTERS: That is your question now that you want answered? Then that doesn't apply to these any more than it does to any other municipally owned utility—in other words that applies to every municipal utility which does not pay taxes directly on its property.

Now, who wants to answer that: either one of the speakers this morning or anyone else here, who is a representative of a utility which does not pay taxes?

MR. PRATHER: I don't know whether I can answer the question. I am putting myself on the spot by getting up here, but I analyze it in this manner: We have a tax-free utility. We carry our electric plant at a book value of approximately $800,000; it is true this doesn't pay anything to the state or to the county; but our state, Iowa, derives a very small percentage of its income from direct taxation.

Mr. Ellsworth mentioned the PWA funds, and I believe he realized that not a penny of PWA funds come from direct taxation. The federal government uses other means to raise its revenues.

For instance, we figure it this way: We are operating a city government for the benefit of the citizens of Ames, Iowa, not for the benefit of the state of Iowa particularly, nor for the county; they have other revenues that they have taken for taxes —that is their problem.

Take, for instance, the school board, which has a tax levying body separate from the city council. We do realize that our schools are essential to the city of Ames, so we give them a twenty-five per cent reduction on all electricity used in the schools. I haven't figured it out as to whether that amounts to the exact amount or anywhere near that exact amount of our ratio of the school tax, but it would be a large percentage of it. We do take that into consideration that way.

But I think you will find out as it is in the state of Iowa, and I think probably in other states, that most of your revenue for your state is taken from other sources rather than your direct tax. The tendency is for your direct tax on property to be left to your cities and school boards.

CHAIRMAN CHATTERS: Do you consider that an answer to your question, in whole or in part?

MR. ELLSWORTH: I think he doesn't answer it, and I apologize for bringing in Coffeyville.

My point was that it was rather amusing that he should use most of his federal funds for the extension of that plant, and I just wanted to bring out that point; but in California, particularly, we have always

looked upon public utilities as a source of revenue. Under the gross receipts tax, it is an important source of state revenue.

Our counties get a great deal of revenue from an ad valorem tax on those properties; the state gets a great deal of revenue from a franchise tax upon those companies; and if the city and county of San Francisco should acquire the Market Street Railway, the state would lose those revenues.

It happens that here the county and city are the same government, so that probably that example is an unfortunate one, but it would apply elsewhere, and they do deprive the local tax base from the value of its utilities and the local coffers of the amount of revenue that would come from the tax upon those properties; and unless the city is entirely self-supporting from the governmental point of view, they get no revenue from the state, no revenue from the county, or no services from the state, or no services from the county. It seems to me that they are dodging their share of the cost of government. We do it, and I wonder what is the answer to the question.

CHAIRMAN CHATTERS: In other words, you think that some communities having utilities which are tax-free and other communities having public utilities which pay taxes, rather unbalances the revenue system and benefits one community as against another?

MR. ELLSWORTH: That is right.

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EDWIN H. SPENGLER

The Increment Tax versus Special Assessments

SPECIAL assessments and unearned increment taxes are first cousins, but they can produce quite different results in practice. The following selection * generalizes the results of an extensive field study comparing these two revenue sources.

In theories of taxation there is a growing tendency to emphasize social welfare considerations. Attainment of justice in the distribution of public impositions is the major problem. The justice of the tax burden is usually determined by the criteria of equality, universality, and uniformity. According to Stephen Weston,[1] equality in taxation means that there should be the same relative economic ability after as before the tax. Today

[1] S. F. Weston, *Principles of Justice in Taxation.*

* *Bulletin of the National Tax Association,* XX, No. 9 (June 1935), pp. 258–261.

the "abstract basis of general taxation is commonly considered to be not the services rendered by the state but the ability of the contributor to pay."[2] The principle of benefit, however, is still important in local finance, where it serves as a partial defense for the level of tax burden imposed upon real estate. It is the basis of special assessments.

"A local assessment (special assessment) levied on the theory of benefits may then be defined as an enforced voluntary charge . . . imposed by competent political authority to raise funds to pay for part or all of an improvement of a public character whereby an especial local benefit has in the contemplation of the law been conferred upon certain property . . . ; imposed in contemplation of the law in return for such special benefits and apportioned to the amount of such special benefits."[3] The essential characteristics of the special assessment are: that it must be for a public purpose; that it must aim at equality and uniformity by some method of apportionment; and that the tax must not exceed the benefit. Victor Rosewater asserts that the justice of the special assessment lies in the fact that the expense incurred by the local authority causes a "special, distinct, measurable advantage" to the property of a particular individual. According to the theory supporting special assessments, the payment is for an exchange. The improvement causes an increase in the value of adjacent real property. The owner is called upon to pay for this special benefit.

Special assessments, or "betterments" as they are called in England, began there in 1662,[4] when an act was passed to authorize the widening of certain streets in Westminster and to provide for the expense involved through voluntary subscription. In case this was not sufficient, the commissioners authorized to lay out the streets could charge the owners of the property in proportion to the benefits received. The system of special assessments in this country was originated in 1691 by the Province of New York, which passed an act empowering the Mayor, Aldermen, and Common Council to impose a tax in proportion to the benefits received from public improvements.

At the present time the purposes to which American municipalities apply their systems of special or local assessments are, generally, the paving and improvement of streets and highways and the construction of sewers and basins. Most of the cities are authorized to charge the expenses of these improvements to property owners benefited by them. The usual method of determining the assessment district is to include all contiguous property, to which the benefits are supposed to accrue. To approximate the benefits resulting to each parcel, the front foot rule is used whenever applicable. In New York City the board of assessors determines the area of the assessment district and the extent of the benefits within it, unless the permanent area has been previously marked out. The law holds that the area should include all lands and premises deemed to be benefited. Within the assessment district the charge is apportioned according to the estimated individual benefit, subject to two limi-

[2] Victor Rosewater, *Special Assessments*, p. 9.

[3] W. Page and J. Jones, *Treatise on Law of Taxation by Local and Special Assessments*, p. 7.

[4] Rosewater, *op. cit.*, p. 9.

tations—first, that the charge does not exceed the benefits; second, that it is no greater than one-half of the assessed valuation of the property affected. Where the area includes only property abutting upon the improvement, the board divides the costs among those liable in the ratio of the frontage of the property assessed. If the district takes in lands not within this rule, the various parcels are marked off into zones according to their comparative proximity to the work. The board acts on the theory that the degree of benefit varies inversely with the distance from the line of the improvement. The abutting property is assessed at so much per front foot or per square foot, the next nearest zone at a lower rate, and other zones proportionally.

The main assumption of the adherents of the system of special assessments is the benefit principle. Arthur Burnstan says that, "to understand the justice of a pure benefit assessment, it is necessary to regard it as a proportional tax on increment, based upon the share of benefit accruing to private property because of public improvement." [5] He, nevertheless, admits that one of the most difficult tasks in special assessment procedure is the solution of the problem of the most equitable standard for the measurement of benefit. The keystone of the system is threatened by practical difficulties. An injustice in the working out of the system is also evident. Whenever special benefit coming to individuals from local improvement is less than the cost of such improvement, the difference is paid from the public treasury at the expense of individuals who do not receive benefit from the improvement. In many instances local traceable benefits *exceed* the cost of construction. The property owner then receives "additional unearned increment" against which there is no levy.

An alternative plan, which has been offered because of these defects in the special assessment system, is the taxation of increased land values. "Economic justification is found for the increment duty in most countries where it has been attempted, on the benefit or betterment principle, that is the resumption by the community of part of the value socially created or created by communal expenditure." [6] The increment tax would be levied against actual growths in value that have occurred from year to year, and, therefore, it would be a tax based on recognized gains instead of on benefits theoretically received.

This is by no means a new form of taxation. A few significant examples of various plans for the use of an increment tax may be cited. In England the "increment value duty" came into existence with Lloyd George's Budget of 1909–1910. A 20 per cent tax was levied on all increments in property values in excess of 10 per cent. If a property increased from £10,000 to £15,000 and then decreased to £10,000, the tax would not be paid again until the value passed £15,000. In 1931 the Town Planning Bill was pending before Parliament. It provided that where land had increased in value owing to expenditure by public authorities the full amount of that increase was to be taken from the owner. In Germany the unearned increment tax began as a local tax in Frankfort in 1904. It spread throughout Germany,

[5] A. Burnstan, *Special Assessment Procedure,* Special Report of the State Tax Commission, 1929, p. 27.

[6] Sir Josiah Stamp, *Fundamental Principles of Taxation,* p. 182.

and in 1911 the law provided for a federal tax to replace all former state and municipal taxes. The *besitzsteuer* was levied in 1917 on the increment of the values of property occurring between 1914 and 1917. The rate varied from 3/4 of 1 per cent to 1 1/2 per cent on increased value. In 1919 the increment tax ranged from 10 per cent to 100 per cent. In 1921 the rates were 10 per cent for an increment less than 10 per cent; 11 per cent for an increment between 10 and 30 per cent. The tax increased by 1 per cent for each 20 per cent increase in the increment until 20 per cent was payable for an increment of from 190 per cent to 200 per cent, and then by 1 per cent for each 10 per cent increment, so that a maximum tax of 30 per cent was paid where the increment exceeded 290 per cent.[7] The German plan, unlike that of England, provided for a second taxation upon a second or duplicated increment.

Many other plans have been presented for a tax on increments in land value. In 1890 *The Financial Reform Almanack* of England mentioned a plan "for the state to appropriate all or part of unearned increments of value in land, as it is due not to the exertions of the landlord, but to the growth and industry of the nation."[8] The social character of increase in land values is here stressed. Adam Shortt of the Civil Service Commission of Canada advocated in 1915 a plan for taxing the accretions of land value. He argued that the increased value of the land was a social creation; and that the landowner also had a peculiar ability to pay not possessed by the less fortunate. The points in Mr. Shortt's plan are:

1. Tax every transfer on its increment.
2. The proceeds are to be kept distinct from the funds currently needed for the city.
3. The proceeds are to be used for special capital expenditures, which were at that time paid for by loans.
4. Property is to be assessed at its actual value.
5. At each transfer the price is to be registered with the title.
6. There is to be a progressive rate for the increment tax.
7. Revaluation is to take place every five or ten years.

In the *Final Report of the Committee on Taxation of the City of New York* (1916), there was a plan by E. R. A. Seligman. He recommended a flat 1 per cent rate on all future increases of land values. The basis from which the future increment was to be estimated was the value at the time that the law was enacted. Because of the depression in real estate, the basis from which the increase was to be calculated was to be any year between 1910 and 1914 that marked the highest assessed valuation, provided the property was not sold in the meantime. If the plot of land was assessed in 1912 for \$10,000 and in 1916 for \$8,000 and if its value in 1917 or thereafter rose, the land would not be taxed on the increment until the value had risen above \$10,000. In this plan Professor Seligman allowed for deduction of any sums paid for special assessments that would increase the value of the land.

[7] E. R. A. Seligman, "Comparative Tax Burdens in the Twentieth Century," *Political Science Quarterly*, March 1924.

[8] *The Financial Reform Almanack*, p. 90.

In a previous publication,[9] Edwin H. Spengler outlined a plan that might serve as a substitute for special assessments. There would be a tax of from 5 per cent to 10 per cent upon the increased value of land in the city recognized in the assessed valuations from year to year. If the land value decreased, there would be no further increment tax until the value of the land rose about its previous highest value. Tests for the justification of the increased valuations would be the same as those used at present. Hearings would be held at which protests would be considered and decisions handed down, and these decisions would serve as a basis for the tax the following year. Properties would bear the burden of taxation in proportion to the gains they received from the general growth of the city. A property owner, instead of paying a special assessment for a doubtful benefit, would pay a tax on the increased value of his land partly due to local improvements.

In order to provide an empirical test of results that might be expected from the substitution of increment taxation for special assessments, an intensive study was conducted in a section of the Borough of Brooklyn, in New York. An area comprising over 400 blocks, or more than 20,000 individual parcels, was selected. This region, known as Flatbush, is a rapidly growing community. The improvements consist for the most part of private residences, apartments, and retail establishments, representing a considerable range in value. Because of the continued development of this section of Brooklyn, accompanied by a rather extensive program of opening up and widening streets and constructing sewers, it was deemed suitable as a sample typifying the experiences of a growing community in a large city.

In brief, the plan of the study may be outlined as follows: tabulation of land values (unimproved) of each of the 20,000 lots was made for each year—starting with 1915 and ending with 1934. Care was taken to note the description and dimensions of each parcel so as to retain identity for comparison over the twenty-year period. Where dimensions changed or lots were merged, the unit was dropped from the sample. Units were also discarded in cases where values were not obtainable for each year. As a result of these deletions, the final tabulations included in round numbers only about half of the original number of lots in this Flatbush area. At the same time that this work was progressing, a separate tabulation was made of special assessments, or "local assessments for public improvements," for each lot within this twenty-year period. The major conclusions of this study are based upon the comparison of these latter levies with a computed "increment tax" determined from the value data covering this twenty-year period.

During the period 1915–1934 inclusive, some 138 separate public improvement projects were completed, and special assessments amounting to $2,551,787 were levied upon property owners in this area to defray part or all of the costs of the improvements. Of this sum, $1,078,192 applied to the parcels excluded from the sample. The remainder, or $1,473,595, was levied upon the 9,817 lots included in the final sample.

To arrive at the maximum incre-

[9] Edwin H. Spengler, *Land Values in New York in Relation to Transit Facilities*, Appendix A.

ment in value of each of these 9,817 lots during these twenty years (avoiding duplicate counting of increments to a given level of value), the land value as of 1915 was compared with the highest valuation for any year subsequent to 1915. Differences in value so obtained formed the basis for the computation of possible increment tax revenues. The application of an arbitrary rate of 5 per cent to these increased land values yielded a total of $2,022,012.80, or substantially more than the total sum levied against these properties in the form of special assessments. A 10 per cent tax would have resulted in revenues of almost three times the size of these assessments and considerably greater than the total special assessment levy applying to the entire section.

In only about 25 per cent of all the blocks included in the sample did the amount of the special assessment exceed the revenue that a 10 per cent increment tax would have produced. In 80 per cent of the remaining blocks, an increment tax of 10 per cent would have returned an amount ranging from a little more than the special assessment to about 10 times as much. The rest of the blocks consist of those where the increment tax would have been still more important relative to the special assessment and those that had had no special assessments within the twenty-year period but that would have been subject to an increment tax burden.

From the administrative standpoint of yield, therefore, it would appear that an increment tax of from 5 per cent to 10 per cent would have been more than sufficient to defray the costs of local improvements previously financed by means of special assessments.

A still more vital problem relating to the financing of local improvements is, however, the matter of equitable distribution of the burden. Special assessments have been defended in the past on the ground that payments for local improvements should be roughly proportionate, in this case, to benefits received. Without even questioning the validity of this hypothesis, the point that is made, in offering the increment tax as a substitute measure, is that special assessment procedure rarely, if ever, distributes the cost in proportion to benefits actually received.

The present study would seem to indicate that the lower-value properties are bearing the greatest relative burden of special assessment levies when viewed in the light of actual value increases. As the property value rises, the ratio of local assessment levies to value increments declines, so that the tax burden becomes regressive in nature. Some of the statistical results leading to these conclusions, as well as other, more detailed accounts of the findings of this study, will be given in forthcoming issues of the *Bulletin*.

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CHAPTER 9

OVER-ALL TAX PROBLEMS

SEVERAL over-all problems of the tax system not previously considered afford interesting and important material for study. One concerns limitations on the power to tax. Although a taxpayer may have the impression that a sovereign government can drain him dry if and as it chooses, it is not quite so bad as that. Certain time-honored limitations, such as the rule that taxes must be levied for a public purpose and another that requires reasonable rather than arbitrary classification, are recognized whether or not they are stated in constitutions. And constitutions themselves may impose other limitations.

Most of the constitutional provisions on taxation in the United States are designed to protect our federal system, under which sovereign states function within a sovereign nation. In other words, a federal system involves a division of sovereignty. The Congress of the United States is confined to certain designated powers, although these may be (and have been) enlarged by interpretation and by the use of the spending power, conditional aids, and taxes for nonfiscal purposes (half fine and half tax).

In protecting our federal system, we have developed the doctrine that the federal government and the states must not tax each other's "instrumentalities." Activities and instruments involved in the functioning of a sovereign power must not be taxed in such manner as to destroy the effectiveness of this power. Here starts a long and tortuous trail in intergovernmental relations and the tax system. Included therein is the much-mooted "tax-exempt security" question.

Many deplore the existence of overlapping federal and state taxes in the income, death, tobacco, and many other tax fields. They say that some of these taxes, notably the income and death taxes, are unsuitable for use by states and municipalities. They would federalize these levies and return some revenue to the states, either through aids or shared taxes. Others argue that the states should not be confined to regressive taxes in their (independent) revenue systems. Numerous devices to improve intergovernmental fiscal relations are proposed. Then too,

there is considerable following for the view that the federal idea itself is antiquated. The problem has received special interest and able treatment in Canada and Australia. Intergovernmental fiscal relations is assured a position of increasing importance in the public finance of the future.

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BURT ESTES HOWARD

Federal State *

PREVIOUS chapters have dealt with specific sources of revenue. This chapter is focused on certain problems of the tax system as a whole. Among these problems is the constitutional basis for taxation—the distribution of and the limitations on the power to tax. Another problem of the same order is that of intergovernmental fiscal relations. Both problems have special aspects and are particularly important in a federal system.

The following three selections are intended to give the student some orientation concerning the institution of federalism:

Definition.—Among the various devices for combining several independent states into a more or less effective union, the so-called federal state is the most perfect. The federal state is distinguished from a unitary state (*see*) in this: "Federalism means the distribution of the force of the state among a number of coordinate bodies, each originating in and controlled by the constitution. Unitarianism means the concentration of the strength of the state in the hands of one visible sovereign power, be the power Parliament or the Czar." As a condition antecedent to a federal state, there must be present a number of countries practically contiguous in territory, possessing by reason of their history, race or common experience the stamp of a single nationality or the instinct of a common national life, as, for example, the cantons of Switzerland, the colonies of America, the several states of the North German Bund. Moreover, in order to preserve a federal state there must be a balance of the cen-

* *Cyclopedia of American Government* (New York: D. Appleton & Co., 1914). Reprinted by permission of D. Appleton-Century Company, Inc.

trifugal and centripetal forces of the combining political factors. There must be a strong desire for union offset by an equally strong resistance to unity. Without the one, federalism is impossible. Without the other, the result will be unitarianism. In the formation of federal states, then, the sentiment of the people seeking a permanent alliance must partake of these two antagonistic elements: a desire for union and a loyalty of each for his own separate state. "A federal state," says Mr. Dicey, "is a political contrivance intended to reconcile national unity and power with the maintenance of 'state rights.'"

Distribution of Powers.—The great problem confronting the organization of several independent states into another form, in which each shall give up a part of its own rights in order to create a strong and effective national whole, is the problem of adjusting the relations of the central government to the government of the several states so as to secure at once harmony and efficiency. This end is accomplished by an accurate division of powers between the two, the national and the state governments, parting to each of these two agencies that portion of governmental activity for which it is best fitted. The general principle governing the distribution of powers is to grant to the general government matters which can best be controlled by it, and to retain for state action those functions which directly concern the people as separate communities. Thus it is generally conceded that the control of foreign relations, the maintenance and command of the armed forces, the making of peace and war, the regulation of post and telegraph matters, coinage and currency, and the administration of customs duties shall be within the power of the central government. In the United States the division of powers is as follows: (1) powers vested in the National Government; (2) powers reserved exclusively to the states; (3) powers, usually called concurrent, which may be exercised by either National or state government; (4) powers denied to the National Government alone; (5) powers denied to the state governments alone; (6) powers denied to both the National and states governments. In the exercise of its powers the general Government acts directly and immediately upon the individual, operating through its own organs. In Germany, in certain instances, the central government acts mediately through the states, forcing its action ultimately by what is known as an "execution." Where the national government occupies a certain field of activity, the operation of the state government in the same field is excluded, or, if concurrent action is permissible, the national government takes precedence when its power is exercised and is exclusive.

Written Constitution.—The distribution of powers between the central and the state governments necessitates the creation of a written constitution in which the various powers are explicitly defined. The details of this division vary under various federal constitutions, but they all rest upon the general principle already enunciated. See, for example, the Preamble to the Constitution of the United States and the Tenth Amendment to that instrument, and the preamble and Article 3 of the Swiss *Constitution Fédérale*. This division of powers between the national and

state governments is one of the essential features of the federal form. The very end to be secured by the formation of a federal state carries with it a partition of powers between the central government and that of the individual states. "The powers given to the nation form in effect so many limitations upon the authority of the separate states, and as it is not intended that the central government should have the opportunity of encroaching upon the rights retained by the states, its sphere of action becomes the object of rigorous definition." This constitution which distributes power between the central government and the individual states must in the nature of things be supreme. The doctrine of the supremacy of the constitution carries with it logically the principle that that instrument of organization must be the "supreme law of the land," as the Constitution of the United States explicitly states (Art. VI, paragraph 2), and it becomes, therefore the final justification for all the exercise of powers under it. Not only is the existence of the federal state based upon the Constitution, but such powers as are exercised by it are exercised by the explicit grant of that document.

Federal Court.—But a "supreme law" implies some body invested with judicial power to interpret it, for the interpretation of a law is a judicial function and belongs to the judicial rather than to the executive or to the law-making branch of the government. It is only in the United States that this doctrine has been carried to its logical issue, and a Supreme Court erected and vested with the power of finally determining questions of legality touching the exercise of powers claimed under the Constitution. It is in the United States alone that federalism has been given its logical meaning and effect, *viz.*, the distribution of the force of the state among a number of coordinate bodies each originating in and controlled by the Constitution. "The legal supremacy of the Constitution," says Dicey, "is essential to the existence of the state; the glory of the founders of the United States is to have devised or adopted arrangements under which the Constitution became in reality as well as in name the supreme law of the land." The interpretation of this supreme law and the application of it to specific cases is placed in the hands of a federal court, which exercises powers coordinate with the legislative and executive branches of the government. This federal court derives its existence, as to the other branches of the Government, from the Constitution (Art. II, Sec. i), and therefore stands on an equality with them. It might seem, at first sight, that the Supreme Court exercises a sort of superior function over the other branches of the Government, in that it may declare, and sometimes does declare, acts performed by the executive and legislature void as being *ultra vires*. But what the court does is merely to say that certain acts were not done in conformity with the grant of the supreme law of the land and for that reason were not legal and for that reason not to be heeded. It does not repeal the act. It declares the act void in the particular case before it.

This logical division of powers, by which the federal idea is carried to its consequential conclusion, finds no place in the federal institutions of Germany or Switzerland or any of the modern constitutions. While

each possesses a federal court invested with large powers of determining questions arising between the federal government and the individual states, none of them have accorded to it the right to pass upon the acts of the legislative branch of the federation as to whether these acts were done in accordance with the express powers granted by the constitution. Such determination is placed in the hands of the *Bundesrath,* in Germany, or in the hands of the Federal Assembly, in Switzerland, thus making the federal tribunal a subordinate, rather than a coordinate, branch of the government. In fact it would seem to be regarded as an unwarrantable restriction on the sovereign will of the state as expressed by the law-making body should the judiciary attempt to interfere or to declare any act which the legislature should pass after due deliberation as *ultra vires* and illegal.

Sovereignty.—It might well be asked where, inasmuch as a federal government is subject to the principle of a division of powers, sovereignty in a federation is located. *Legal* sovereignty is located in that institution which has the power, in the last analysis, of altering or amending the constitution by legal means. This power varies in various federal governments, but it may be generally conceded that the sovereign power of a state is found in that body which can impose its will upon state form through legal amendment of its constitution. Thus the five leading systems of federal government differ from one another in their power to modify their organic law. In the United States, changes in the Constitution can be brought about by the sanction of three-fourths of the states, and no state can be deprived constitutionally of its equal representation in the Senate without its consent (Art. V). In Switzerland, the federal constitution can be revised only by a combined majority of the Swiss people and of the Swiss cantons, nor can any amendment of the constitution be effected constitutionally which is not approved by a majority of the cantons. Under the organic law of Germany amendments may take place through the federal legislature in the way of ordinary legislation, but no law amending the constitution can be carried if opposed by 14 votes in the *Bundesrath.* Certain rights are also guaranteed to several states which cannot be changed without the consent of the state affected. The constitutions of Canada and of Australia, being acts of Parliament, may be altered or even abolished by an act of the imperial Parliament.

Dual Citizenship.—In acquiring citizenship in a federal state, the duality existing relative to other matters is found here. Theoretically, the task of differentiating foreigners from subjects and citizens of a state would seem to be almost mechanical. This is particularly true of a unitary state. There arises but a single question: what is the relation of this person to the state as against any and all foreign states? In a federal state, however, the matter is complicated by the fact that every individual stands in a dual relationship; on the one hand he sustains certain relationship to the federal state as a whole, and on the other he sustains certain relations to the individual state in which he resides. The moment an attempt is made to define the status of such a person, not one but several questions arise: What is

the relation of the person to the federal state as against all other foreign states? What is his relation to the state in which he resides? What is his relation to the other federated states of the Union? Is it possible to become a citizen of one state and not of the federation? Are there two or more independent citizenships, each occupying its own sphere, or is there a double citizenship of such a nature that one is superimposed upon the other, is dependent upon the other, exists because of the other, not coordinate but subordinate? In such case, which is primary? Which controls the matter of naturalization? In the United States, under the Constitution (Art. I, Sec. viii, paragraph 4), the Federal Government alone controls citizenship and naturalization. Citizenship of the Union is primary. Whoever becomes a citizen of the United States becomes at the same time a citizen of that state in which he secures a domicile, irrespective of his own desires. In Germany, on the contrary, and in Switzerland, citizenship in the individual state or canton is primary. A person becomes a citizen of Germany or of Switzerland by first becoming a citizen of the state or of the canton, though the states suffer certain limitations as to citizenship under the federal constitution of both countries.

Modern Tendency.—The incapacity of individual states to live alone, and a desire on the part of governments to enjoy the privileges of greatness without possessing the means to achieve it by themselves, were the prime reason and motive for adopting the federal form. Federalism, however, has shown weaknesses upon its economic and social side. The legalistic spirit turns instinctively to the Federal Government as the sole competent organ of sovereignty in the country, hence, as in the United States, every resource of legal ingenuity is strained to bring rights and interests under the federal jurisdiction. In other words, with its later growth there is an obvious tendency on the part of federalism to modification looking toward increased centralization. In fact it is a fair question whether, in view of the modern trend, federal government is to be regarded as a final and permanent form of government, and not rather as a step on the way of those states which have been too insistent on state rights to form a democratic unitary republic.

STEPHEN LEACOCK

The Limitations of Federal Government *

* * * *

It is true that federalism has thus offered a means of harmonizing the differences of communities so divergent in certain respects that complete union was neither possible nor desirable. The huge dominion of the Virginia of 1787 was thus combined with Delaware; under federalism was found in 1867 for the first time a solid basis of union for French and British Canada. And in certain cases and under certain circumstances it may well be conceived that federal union might continue indefinitely as the form of government most suitable to the general environment. This will be the case wherever such natural barriers or actual distance exist between the component parts of the state as to preclude an economic and industrial integration. The union, sometimes proposed, between Canada and the British West Indies, or the union that was long advocated between New Zealand and Australia, could certainly be best accomplished and could best continue on the ground plan of a federal structure. In these cases the partial separation of legislative power only reflects the actual physical separation and the divergent economic life of the two countries. But where a contiguous territory, a homogeneous population and a lack of natural boundaries are found, there a federal form of government, however useful it may be as a preliminary bond of union, becomes increasingly a misfit and with the progressive integration of the general industrial life of the community proves itself an obstructive force upon the path of national progress. Especially is this the case under the conditions developed in the last half century, when the progress of transportation and communication have occasioned a general fusion of economic and industrial life over vast areas. The federal relation between, let us say, the New York and the Massachusetts of a hundred years ago rested upon an actual physical and economic separation; the federal separation of Ohio and Indiana, or of the two halves of Dakota today rests upon nothing but a form of constitutional contrivance at variance with the industrial life of the community. It thus appears in the course of industrial evolution that what was at its inception a political expedient of the highest value in the circumstances of the time wears an entirely different aspect in the light of an altered situation. In only one country of the world—the United States of America—has this situation as yet fully developed, and the case of the United States is therefore specially discussed in the present paper. Of the other federal states, some present an economic life still very largely

* *Proceedings of the American Political Science Association,* V (1908), 37–52.

decentralized and disintegrated; others contain in their structure certain modifications of federalism which give them something of the legislative elasticity of a unitary organization. In Canada, to a great extent, the provinces represent either singly or in contiguous groups, distinct economic units. Ontario and Quebec, separated by natural boundaries and inhabited by people of different races and divergent traditions, fit with perfect harmony into a federal union. There is nothing unnatural or distorted in the fact that their legislative code in regard to labor, religion, and education should be framed upon distinct lines. The maritime provinces are also sharply separated in economic interest and by natural barriers from the rest of Canada and, geographically speaking, form distinct units even among themselves. Between Ontario and the west is a wide stretch of practically uninhabited country. The isolation of British Columbia speaks for itself. It is only on the plains of the west that the federalism of Alberta, Saskatchewan and Manitoba, effected by the adventitious aid of meridians of longitude, wears a suspicious appearance. It is true moreover that the structure of the Canadian constitution contains features of centralization which in many respects almost remove it from the category of federal governments. An analysis also of the Australian Commonwealth would show that the existing six states represent as yet distinct units of population, with physical barriers or uninhabited country interposed, and retain to a considerable extent a distinctive economic life corresponding to the political structure of the Commonwealth. But it is inevitable that in both Australia and Canada a further growth of population and the future integration of commercial and industrial interests will bring about a political misharmony similar to that now existing in the United States. The case of the German Empire stands by itself, for here federalism rests upon a distinctive historic and dynastic basis, and the peculiar operation of the constitution under the dominance of the King of Prussia obviates to a great degree all question as to *ultra vires* legislation.

It is therefore in the United States par excellence that the economic limitations of federal government have appeared and it is to that country that one must turn to study the general problem here presented. The central fact of the situation is that economically and industrially the United States is one country, or at best one country with four or five great subdivisions, while politically it is broken into a division of jurisdictions holding sway to a great extent over its economic life but corresponding to no real division either of race, of history, of units of settlements or of commercial interest. Metternich once said sneeringly of Italy that it was only a geographical expression. One cannot say even as much as this of such divisions as Utah or South Dakota. At best they are astronomical expressions whose location can only be found by the aid of a solar observation. The true meaning of this comes out when we consider to what a very great extent the progress of transportation, of intercommunication and the expansion of modern business enterprise has unified vast stretches of the United States, has rendered the whole country economically interdependent. The process which has been called the territorial division of labor has

been carried forward until producer and consumer in every part of the Union are in close business relation with one and the other, each part of the country being very largely devoted to the raising or manufacturing of products for the use of itself and all the others. How little this economic interdependence harmonizes with the legislative separation into state jurisdictions may be realized by a consideration of the way in which industrial life in the United States has grouped itself upon the principle of the territorial division of labor, regardless of state lines. A few conspicuous illustrations will suffice for the present purpose. In the year 1900, of the $101,000,000 worth of agricultural implements manufactured in the whole country, 41½ per cent came from Illinois: of boots and shoes, out of a total product of $261,000,000, Massachusetts produced 44.9 per cent: the same State is credited with 32.8 per cent of the manufacture of cotton goods: in the making of fur hats four states represented a total of 88½ per cent: in the glass industry two states, Pennsylvania and Indiana, were responsible for 65 per cent of the total product: of the iron and steel manufactures valued at $804,000,000 Pennsylvania produced 54 per cent: Ohio and New Jersey made 65 per cent of the pottery and clay products of the United States: Illinois did 40 per cent of the meat packing: three states produced 48 per cent of the pulp and paper made in the country: four states manufactured 88 per cent of the jewelry: Connecticut alone made 63 per cent of the clocks: California 60 per cent of the wine: Maryland canned 65 per cent of the oysters and New York alone supplied 99 per cent of the collars and cuffs of the United States.

Corresponding to this integration of industry is the progressive unification of control: the transportation system of the country has long since discarded state lines in its organization. The group of companies known as the Vanderbilt system operate some 20,000 miles reaching from New York City to Casper, Wyoming, and covering the lake states and the area of the upper Mississippi: the Pennsylvania system with 14,000 miles covers a portion of the same territory, centering particularly in Ohio and Indiana: the Morgan system, operating 12,000 miles, covers the Atlantic Seaboard and the interior of the Southern States from New York to New Orleans: the Morgan-Hill system operates 20,000 miles from Chicago and St. Louis to the state of Washington: the Harriman system with 19,000 miles runs from Chicago southward to the Gulf and westward to San Francisco, including a Southern route from New Orleans to Los Angeles: the Gould system with 14,000 miles operates chiefly in the center of the middle west extending southward to the Gulf: in addition to these great systems are a group of minor combinations such as the Atchison with 7,500 or the Boston and Maine with 3,300 miles of road.[1]

Analogous to this integration of industry of transportation is the progressive consolidation in the control of capital entirely disconnected, on its economic side, from the boundary lines of the state. This phase of American development is almost too familiar to require even the briefest citation. It has been recently esti-

[1] Statistics based on the Reports of the Interstate Commerce Commission and quoted by Mr. H. T. Newcombe, "Recent Great Railway Combinations." *American Review of Reviews 1902.*

mated[2] that the seven greatest industrial combinations of the United States represent a capitalization of $2,662,752,000, that below these are 298 organizations representing the consolidation of 3400 original plants: and that the aggregate capitalization outstanding in the hands of the public of 318 important and active industrial trusts in this country is at the present time no less than $7,246,000,000, and covers practically every line of productive industry in the United States.

Alongside of this national consolidation of interest in the control of capital is seen the organization of the forces of labor into vast groups representing the economic solidarity of the whole nation. The enormous membership roll of the Federation of Labor, or of such bodies as the railway brotherhoods, the United Brotherhood of Carpenters of the United Mine Workers of America shows the extent of this process. These associations either disregard state lines in their organizations or make use of them only as a matter of convenience. Their essential aims and collective activities are not associated with the separate states as economic areas.

Over against this is to be set the political organization of the country. Here we have the national government and along side of it 46 separate jurisdictions. According to the text of the constitution almost the whole economic field is given over to the latter. To the central government, still according to the text of the constitution, is entrusted only such control as arises out of the commerce clause, the general welfare clause and other familiar portions of Art. I, Sec. 8. The rest of the economic field except in so far as it is diminished by the restrictive operation of the amendment falls under the control of the state governments. In the days of Alexander Hamilton this allotment of jurisdiction corresponded with the actual facts of economic life. Today it does not. Yet it is remarkable how imperfectly even the most learned commentators on the constitution of the present time seem to realize the serious distinction between law and fact that thus arises. "The federal powers" writes Professor Stimson, "are political: that is the great criterion. The state powers on the other hand are domestic, social."[3] When it is seen that the sequel of Professor Stimson's discussion shows[4] that his use of the word "social" includes *commercial,* it might almost be thought that under modern conditions such a description of a federal system would contain in itself a serious indictment.

I am quite aware that hitherto I appear to have left out of consideration the very essence of the matter. The question of implied powers and of the expansion by federal control, the powers of judicial interpretation rises at once to one's mind. We have been told since childhood that the constitution of the United States is a document drawn in singularly simple and elastic terms: that the courts, following the leading of the eminent Marshall, have taken advantage of this to effect a progressive increase of federal power by the process of interpretation; that thus there have been "read in" to the constitution new powers to meet the needs of suc-

[2] Mr. John Moody, *Encyclopedia Americana,* Article on Trusts.

[3] *The Law of the Federal and State Constitutions of the United States* (1908), Chap. 10, p. 69.

[4] *Op. cit.*, p. 71.

ceeding generations. "The commerce clause," says Mr. Frederick Judson, "written for the days of the stage coach and the sailing vessel has been adapted by judicial construction to an age of steam and electricity."

I readily grant that judicial interpretation has done much: that by its means federal power has been enormously increased; that without it the whole system would have terminated long ago in general shipwreck. But that it has really and adequately met the economic needs of the situation or that it ever can do so, is a proposition to which I hesitate to assent.

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ELIZABETH BRANDEIS

The States and Democratic Government *

* * * *

Most important of all, we must preserve the states because they are indispensable to a democratic system of government. We dare not transfer too many functions of government to Washington for fear of destroying the roots of democracy without which the whole tree will wither and die. This is far more than a mere figure of speech. For after all, what is a democratic system of government? Universal suffrage is not enough; not even when coupled with protection to civil and political liberty.

Democratic government means government *by the people,* not just on Election Day, but all the year round. It requires real participation in government by private citizens—not by all of them perhaps, for that would be Utopia, but by a really substantial number. In a democracy, private citizens must function, must take an active part in the governing process, and so their opportunities to do this must be guarded and strengthened, not weakened or destroyed.

What has this to do with the importance of state government? The answer is simple. Average citizens can function in government only when it is near enough to be accessible and small enough so they can make a dent. Anyone who has worked for legislation in a state capital and in Washington knows the difference. In a state, public spirited citizens can really make themselves felt, for a state legislator takes a call from two constituents seriously; he has no secretary, so he reads his own mail. In Washington, you can do little with-

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out extensive and expensive organization.

The work of the League of Women Voters well exemplifies the difference in the character of citizen participation in government on the state and national scene. On the state and local level, League members are active citizens. They really function effectively. Housewives actually can and do find the time to study issues, arouse their neighbors, attend hearings, and interview their legislators or administrative officials. They can get away from home long enough to get to the state capital. But most of them cannot get to Washington; so on the national level the work of the League must be carried on for the most part by full time national officers.

The situation is the same for other groups. Take farmers, for instance. In Wisconsin when a measure affecting agriculture is up for hearing, real "dirt farmers" can and do throng the capital. They can get as far as Madison to tell their legislators what they want; and get home again to most parts of the state "in time," as they frequently say, "to milk the cows." But they can't get to Washington; so congressmen have mostly federal officials and professional lobbyists to listen to. On the national level, working for legislation is necessarily a large scale business, possible only for well organized and well-financed pressure groups. In the states, individuals and small groups can still function and make a dent. In short, participation in government on the state and local level is open to amateurs; nationally it is limited practically to professionals.

Citizen participation is needed in the administrative as well as the legislative process. Vast powers are now delegated to administrative agencies, remote from popular control. Top officials frequently are appointed for terms of years, and even a new chief executive cannot effect a change in the policy of the agency before his own term expires. There is real danger that the heads of such agencies may become our masters instead of our servants. Our forefathers sought to prevent bureaucracy by rotating government jobs. We realize that this is not the solution. Technical training and experience are too valuable in the complicated task that governmental agencies must perform. Instead, we must give private citizens a place in the administrative process. They have long had a place in the judicial process—as members of the jury. The British use them in a variety of ways in many fields of administration, on advisory committees and quasi-judicial tribunals of many kinds. Advisory committees made up of employer, labor and public representatives are used in many states in the administration of labor laws. This kind of citizen activity needs extending.

The participation of private citizens in the administration of specific laws which directly affect them does not encounter the inertia or indifference which often keep citizens from exercising the general powers which they possess. Members of such advisory committees really give time and thought to the work, well recognizing the importance of what they are asked to do. Thus the committees constitute a school for citizenship in which the pupils (in accord with modern educational principles) "learn by doing." Through these committees, too, the administrator is brought face to face with his constituents, that is, with that segment of the public di-

rectly affected by what he is doing. Such committees operate to protect him from conflicting pressures by the affected groups. For in such committees the groups resolve their conflicts through conference and compromise —a kind of collective bargaining, if you will; and administrative government is thus democratized by their active participation.

Citizen participation in government through the use of advisory committees cannot be very effective on a national scale. If local committees are set up, but matters of policy are all decided in Washington, committee members soon sense that they are only local window dressing. Then they usually lose interest; for grown-ups do not care to play at governing. On the other hand, a national advisory committee suffers from the difficulties of size and geography. It is too far for rank-and-file individuals to go to frequent meetings. Labor, at least, is usually represented by its national officers, its own bureaucracy. And the committees get large and formalized and frequently they are steered to save time. The advisory committee is a plant which flourishes best in the home environment.

Unemployment compensation is one of the fields where administration especially benefits from the participation of employers and labor; their watchful interest helps to prevent abuses or inefficient operation. Such participation, through direct contacts and through advisory committees, can best be secured when unemployment compensation is administered as a state function.

Of course, participation by private citizens in the government process slows things up. The democratic way always takes more time. It is quicker to give a command than to reach agreement in a conference. It takes much less time to issue an executive order than to put a bill through two houses of a legislative body with public hearings in both houses. And it may take longer to get a given type of law passed in all forty-eight states than in one national Congress. On the other hand, it should be remembered that such a law may not be needed in all the states, or a different law might be much better in some of them. And some states could probably pass a much better law than any which could be passed in Congress. In any event, speed is not the main criterion. There are many short-cuts in government that we cannot afford—the price is too high.

In the years ahead, though we cannot see the pattern plainly, we know that government in this country will have to carry a greatly increased load. Our government can carry it, of course. The governments of Germany and Russia have carried even heavier ones. The question is: can government carry that load and remain democratic government? That question is still unanswered in any large country. Success in the Scandinavian countries is not relevant, because their size makes them more analogous to our states. And Great Britain with a population less than 45,000,000 is divided for many governmental purposes into England, Scotland, and Wales.

Democracy is not merely a form of government. It is a faith. In this country we believe profoundly that government *by* the people, though it will never be perfect, is better than any other form of government. But faith alone is not enough. To maintain democratic government, we must take care to preserve and develop arrangements by which private citi-

zens can function effectively in the government process. That means, above all, keeping as much government as possible "back home" in the forty-eight states where private citizens live.

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BRECK P. McALLISTER

Public Purpose in Taxation

TURNING next more specifically to the power to tax, we observe a rule of taxation not found in the constitution but developed independently by the courts. This is the rule holding that taxation must be for a public purpose. The evolution of this doctrine is described in the following selection: *

Let us suppose that an ordinary taxpayer should learn that his municipal government is proposing to spend a considerable sum in constructing and operating a municipal fuel yard and a municipal ice plant. If he is of an economical turn of mind and is bold enough to probe into the mysteries of the law he might ask his lawyer how this can be stopped. He will be met with the reply that sometimes an expenditure for a municipal fuel yard is constitutional and sometimes it is not, and that the same is true of a municipal ice plant. If he presses the inquiry further his lawyer will tell him that if these expenditures for municipal projects are to pass the judicial test of constitutionality they must be found by the courts to serve a public purpose. If they are found to serve a private purpose they will be declared unconstitutional for the reason that this would amount to a perversion of the taxing power. But what is public and what is private, and by what power do the courts have the last word, and why have they differed over fuel yards and ice plants, and how have they distinguished between the two? These are questions which quite naturally occur to our inquisitive taxpayer.

Let us return to this notion of public purpose. At the outset it may be noted that questions of how revenue is raised are excluded from our consideration. We are not concerned with problems of jurisdiction to tax,

* Reprinted by permission from *California Law Review*, XVIII (1929), 137–148. [Footnotes omitted.]

classification for taxation and taxation for regulation in its milder or extremer forms. All these, whether they have as their object revenue, regulation or both, raise other constitutional issues. They are all on the revenue-raising side of the taxing power. The question of public purpose is not raised until the government starts, or proposes to start, spending.

It was to curb governmental expenditures that the doctrine of public purpose was first used in the state courts, during the first half of the last century. It was there said that the exercise of the taxing power for other than a public purpose was unconstitutional. The courts, both state and federal, have since then taken it upon themselves to declare that a given expenditure is or is not for a public purpose. The doctrine has become "settled," and seems to be gaining in importance in this period of increasing governmental activity and coincident expenditures. In eleven states the constitutions have codified the doctrine, usually in the proposition that "All taxes shall be levied and collected for public purposes only," and in recent years this doctrine has become a part of the due process clause of the Fourteenth Amendment and, vicariously, that of the Fifth Amendment. It has been held to be a deprivation of property without due process of law if public funds are spent for other than a public purpose.

In general the issue of public purpose is raised in two classes of cases: (1) those involving governmental aid to private individuals or corporations, (2) those involving the assumption by government of new functions.

* * * *

1. *Origins of the Doctrine*

For many years public money was spent in America without any judicial scrutiny of its purpose. However, in 1837 the Virginia court had before it the question of the validity of a municipal expenditure for a state canal project. The expenditure was allowed but not without a dissenting voice. The municipality was limited to expenditures of a corporate character, and, said the lone dissenter, to hold that a great canal project was a local purpose "Would violate the 6th article of the bill of rights, by taking private property for public purposes without compensation."

Other than this dissent the only glimpses into the future are found in occasional arguments of counsel that municipal subscriptions to railroad, turnpike and canal companies were for a private purpose. To this argument the courts maintained an abysmal silence. But not so when it was argued that these subscriptions involved a taking of private property for a public use without compensation. This argument had a familiar ring and the courts deferred to counsel to the extent of pointing out the error of their way in supposing that the power of eminent domain had anything to do with the power of taxation.

In 1849 we find the Supreme Court of Pennsylvania stating that: "From the commencement of the government, our representative bodies have exerted the unchallenged power to levy taxes . . . for every purpose deemed by them legitimate." This may be taken to be a fair statement of the view prevailing up to the half-century mark.

A. *Government Subsidies: Railroad-Aid*

In the meantime forces were at work which had as a by-product the presentation to the courts, both state and federal, of questions of the utmost importance to the commercial development of the country. The years 1840 to 1890 roughly mark the period of construction of the great railroads of America.

Government aid to the railroads was the cry of the day. The railroads wanted land and money and the towns wanted the railroads. The advent of the railroad meant prosperity and to let the iron horse pass by meant inevitable decay. This formula, plus promises of large dividends, caught the popular imagination and from every public source, from Congress down to the humble township, land and money poured into the railroads. These aids took the form of subscriptions to railroad stock, outright gifts of lands and money, or gifts of municipal or state bonds. In time disillusionment followed and the municipalities found that dividends were scarce, that they had been played off against each other and were over their heads in debt with the alternatives of bankruptcy and repudiation. They resisted payment of their securities and carried their resistance into the highest courts. There they urged, among other things, that railroads were private corporations, and that they themselves had misbehaved badly in spending the public money to assist private corporations. Their conduct, they said, was unconstitutional for, was it not clear, that public money could only be spent for a public purpose. In this period of frenzied finance the doctrine of public purpose was advanced in an effort to repudiate millions of dollars worth of municipal and state bonds held by bona fide purchasers. Some courts listened, but the great majority turned a deaf ear.

The burden of all this finance fell, of course, upon the taxpayers and the first important case in the state courts, that of Sharpless *v.* The Mayor of Philadelphia in 1853, took the form of a taxpayer's bill. The object of this bill was to enjoin the mayor and aldermen of Philadelphia from subscribing to the stock of two railroads and from selling bonds to the sum of $1,000,000 to finance the purchase. The defendants set up legislative authorization. The court dismissed the bill, two of the five justices dissenting. Chief Justice Black for the majority found himself in a dilemma. On the one hand, he pointed out that no less than $14,000,000 worth of railroad stock had been subscribed by cities and counties in the commonwealth. On the other hand, he pictured the financial ruin which must fall upon the cities and counties if this burden was to be sustained as constitutional. "But," added the Chief Justice naively, "All these considerations are entitled to no influence here. We are to deal with this strictly as a judicial question." The Chief Justice disclaims any power to declare the act unconstitutional merely because "it impairs the spirit of our institutions." There must be some express constitutional provision which is "clearly, palpably, plainly" violated. He then shifts ground and points out that the taxing power is granted "without any restriction whatever" but hastens to add that "I do not mean to assert that every act which the legislature may choose to call a tax law is con-

stitutional." This is elucidated in unmistakable language. The legislature, we are told, has no constitutional right—

> to create a public debt, or to lay a tax, or to authorize any municipal corporation to do it, in order to raise funds for a mere *private* purpose. No such authority passed to the Assembly by the general grant of legislative power. This would not be legislation. Taxation is a mode of raising revenue for *public* purposes.When it is prostituted to objects in no way connected with the public interests or welfare, it ceases to be taxation, and becomes plunder.

Here is the first clear-cut statement of the doctrine. Chief Justice Black finds its source implicit in the word "taxation." By definition he supplied the "express Constitutional provision" which, we have been told, must be "clearly, palpably, plainly" violated before the act may be declared unconstitutional. Obviously this definition was supplied by Chief Justice Black. It is not to be found in the Constitution of the Commonwealth of Pennsylvania. The remainder of the opinion is devoted to showing that the expenditure here was for a public purpose.

The Chief Justice said, among other things, that the railroad enjoys the right of eminent domain and that this cannot be used for private purposes. It follows, he says, that the railroad through its enjoyment of the power of eminent domain has acquired a public *status*, and therefore may be aided by taxation. It would seem obvious that the grant to a railroad of the power of eminent domain does not involve any expenditure of public money, and equally obvious that the grant of aid through the taxing power does involve such expenditure. Further, the fact that the state has given a railroad one bounty in the power of eminent domain, might well be a better reason against, than for, giving it another bounty through the taxing power.

The curious feature of Chief Justice Black's opinion is that he might so easily have reached his result without enunciating the doctrine of public purpose. In fact, his brethren, Justices Woodward and Knox, did just that. In their concurring opinions both of them were content to state that they could find no constitutional provision which had been clearly violated. It must always remain somewhat of a riddle why the Chief Justice did the pioneer work of setting up this new doctrine when he could so easily have followed the beaten path. To the technically minded the reference to public purpose might be dismissed as *dicta*. But whatever Chief Justice Black's utterance may be called the point that interests us is that while other portions of his opinion have gone unheeded, and perhaps unread, his enunciation of the doctrine of public purpose appears in the forefront of many later opinions with all the majesty of authority.

It would profit little to pursue the course of railroad-aid bonds through the courts. It has been estimated that in the period between 1860 and 1891 no less than three hundred cases came before the Supreme Court alone. In not all of these was the question of public purpose presented, for by 1873 we find Mr. Justice Strong making the statement that the question ought to be considered as settled. In the state courts railroad-aid bonds sailed a smooth course, and the reasoning of Sharpless *v.* The Mayor went unchal-

lenged, except in the courts of Iowa, Wisconsin and Michigan.

In Michigan the figure of Judge Cooley stands out as the spokesman of the judicial protest against the validity of railroad-aid bonds. His is almost a lone voice, and it is a voice raised in the face of the pressure of the contrary decisions in eighteen out of twenty states which had passed on the question as well as the federal courts. Such judicial unanimity could not be lightly brushed aside. Judge Cooley's task involved a fresh approach and the abandonment of the major premise involved in the contrary decisions.

* * * *

B. *Government Subsidies: Aid to Other Industries and Persons*

The railroads were not the only enterprises that clamored for public funds. Industries were equally importunate. Often, as with the railroads, particular industries held aloof from a town unless the municipal authorities were willing to offer a pecuniary inducement to their entry. This situation gave rise to the expenditure of municipal funds to support existing industries and as bait to new ones. In a period of industrial growth these expenditures might well have been found to be a constitutional use of public funds. But as a rule the courts, both state and federal, have held these bounties to be for a private purpose and therefore unconstitutional. In reaching this result the courts have distinguished the railroad cases.

Before turning to these cases, it may be well to note an influential Massachusetts case. This curious decision brings into sharp relief the relation between the immediate private benefit and the ultimate public gain which is involved in government subsidies. This is the case of Lowell *v.* Boston. Following the Boston fire of 1872, the legislature of Massachusetts authorized the city of Boston to issue bonds to an amount not exceeding $20,000,000 for the purpose of making loans to individuals for rebuilding in the burned area. The court enjoined the issue of the bonds. For the first time an express constitutional sanction for the action of the court might be found, though there is no indication that the court placed any great reliance upon it. The court followed in the path of earlier decisions and identified the notion of "public service" with that of "public use" in eminent domain. This identity was established to show that under the Massachusetts decisions the power of eminent domain might be exerted only for use by the public. From the premise of identity it followed that the same thing must be true of the power of taxation. It is clear that the money was intended for use by private individuals for the purpose of rebuilding private dwellings and business houses. The benefit to the public was said to be merely incidental.

When the court sets up the category of direct and substantial or indirect and incidental public benefits the final decision will depend on the judgment of the court as to which social values shall prevail. In the railroad-aid cases the public funds went immediately into the coffers of the railroad companies. Does this mean that the benefit to the private companies is direct and substantial and the benefit to the public is indirect and incidental? The courts avoided this with the formula that railroads, though pri-

vately owned, and operated for private profit, were "public" corporations.

* * * *

The other case which it is proposed to discuss is that of Loan Association *v.* Topeka. The city of Topeka, under authority of an act of the legislature of Kansas in 1872, issued $100,000 worth of bonds as a donation to the King Wrought Iron Bridge Manufacturing and Iron Works Company on condition that it should establish its factory in that city. The Citizens' Savings and Loan Association of Cleveland, a holder for value of some of these bonds, brought suit against the city for interest in the circuit court for the district of Kansas. The court sustained a demurrer to the complaint and gave judgment for the city. This was affirmed on writ of error to the Supreme Court.

Mr. Justice Miller dealt with the question solely on the ground of public purpose. He pointed out that the railroad-aid cases had all recognized the doctrine of public purpose and that the differences of opinion had been as to whether or not railroads were to be deemed objects of public bounty. Turning to the question in the principal case, he remarked that courts "must be governed mainly by the course and usage of the government." However, he added, "this may not be the only criterion of rightful taxation." In reaching a conclusion on the particular facts, the opinion of Mr. Justice Miller presents a curious parallel to the opinion of Mr. Justice Appleton in Allen *v.* Jay just considered. Mr. Justice Miller could see that the industry would be of "benefit" to the town, but, he said, "No line can be drawn in favor of the manufacturer which would not open the coffers of the public treasury to the importunities of two-thirds of the business men of the city or town." Translating this argument into an argument concerning the scope of the taxing power, he found that the expenditure of public funds in this case was for a "private" purpose, and therefore unconstitutional.

The unanimity of the courts was marred by the frank dissent of Mr. Justice Clifford who declared that "Courts cannot nullify an act of the State legislature on the vague ground that they think it opposed to a general latent spirit supposed to pervade or underlie the constitution, where neither the terms nor the implications of the instrument disclose any such restriction." This is the language of a prophet of a more critical age.

Several points may be noted in this case. In the first place, it involved the acceptance of the doctrine of public purpose in taxation by the highest court in the land. In the second place, the decision is not grounded in the due process clause of the Fourteenth Amendment. In some later decisions this was supposed to be the case, and this view has been taken by some writers. Nowhere in the opinion is there any reference to the due process clause. Further, the case reached the Supreme Court from a lower federal court so that there was no necessity of finding a question under the Federal Constitution. It was not until later that the doctrine of public purpose was admitted into the close of due process. In the third place, the decision involved repudiation of the bonds, as they had been sold in the market, and the decision was made in the face of a determined

stand against repudiation of municipal bonds held by bona fide purchasers.

The almost universal current of authority has denied the validity of state and municipal aid to industry. The Loan Association case is usually cited after a dogmatic assertion of the doctrine. It has been pointed out that the props are none too strong. Had later courts wished to be critical, they would have found sufficient to criticize and these cases might have found repose with the convenient label of "anomalous." But such has not been their fate. They have prospered and today enjoy a vitality which their questionable origin might not seem to justify. It is not hard to understand this. The judicial mind was no doubt outraged at the thought that the public money might be spent for what they conceived to be private purposes. In this the judges simply reflected the reaction of other taxpayers. Most of the judges were undismayed at finding no constitutional provisions. Some clutched at the nearest straw—the power of eminent domain. That said something about taking private property for a public use. Others sought a prop in the definition of a tax and cited *Webster's Dictionary*. Others did both and topped it off with an essay on the nature of all free governments.

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JUSTICES FRANKFURTER AND DOUGLAS

Decisions in State of New York v. *U.S.*

ANOTHER doctrine developed by the courts is that sovereign governments in a federal system may not tax each other's instrumentalities. This goes back to the famous case of McCulloch *v.* Maryland, decided in 1819, in which the state was barred from imposing a special tax upon a branch of the United States bank. Since then the issue has appeared in many cases and frequently it has been decided with a divided Court. The issue arose in the recent case of New York *v.* U.S. upon which the Court again divided. Two of the opinions, one representing the majority and the other the minority view, are reproduced here: *

* 66 Sup. Ct. 310, Jan. 14, 1946. [Some of the case citations have been eliminated.]

Mr. Justice FRANKFURTER announced the judgment of the Court and delivered an opinion in which Mr. Justice RUTLEDGE joined.

Section 615 (a) (5) of the 1932 Revenue Act, 47 Stat. 169, 264, 26 U.S.C.A. Int. Rev. Acts, page 614, imposed a tax on mineral waters.[1] The United States brought this suit to recover taxes assessed against the State of New York on the sale of mineral waters taken from Saratoga Springs, New York.[2] The State claims immunity from this tax on the ground that "in the bottling and sale of the said waters the defendant State of New York was engaged in the exercise of a usual, traditional and essential governmental function." The claim was rejected by the District Court and judgment went for the United States. The Judgment was affirmed by the Circuit Court of Appeals for the Second Circuit. The strong urging of New York for further clarification of the amenability of States to the taxing power of the United States led us to grant certiorari.

On the basis of authority the case is quickly disposed of. When States sought to control the liquor traffic by going into the liquor business, they were denied immunity from federal taxes upon the liquor business. State of South Carolina *v.* United States, 199 U.S. 437, 26 S. Ct. 110, 50 L. Ed. 261, 4 Ann. Cas. 737; State of Ohio *v.* Helvering, 292 U.S. 360, 54 S. Ct. 725, 78 L. Ed. 1307. And in rejecting a claim of immunity from federal taxation when Massachusetts took over the street railways of Boston, this Court a decade ago said: "We see no reason for putting the operation of a street railway [by a State] in a different category from the sale of liquors." Helvering *v.* Powers, 293 U.S. 214, 227, 55 S. Ct. 171, 174, 79 L. Ed. 291. We certainly see no reason for putting soft drinks in a different constitutional category from hard drinks.

One of the greatest sources of strength of our law is that it adjudicates concrete cases and does not pronounce principles in the abstract. But there comes a time when even the process of empiric adjudication calls for a more rational disposition than that the immediate case is not

1 "Sec. 615. Tax on Soft Drinks.

"(a) There is hereby imposed— * * *

"(5) Upon all natural or artificial mineral waters or table waters, whether carbonated or not, and all imitations thereof, sold by the producer, bottler, or importer thereof, in bottles or other closed containers, at over 12½ cents per gallon, a tax of 2 cents per gallon."

2 The history of New York's relations to the springs at Saratoga may be briefly summarized. Under previous private operation the flow of the springs had been substantially diminished by excessive pumping. In 1911 the State of New York began to acquire title to all the lands on which the mineral springs were located at Saratoga Springs. In order to conserve the springs for beneficial operation, the State took various measures until, in 1930, control over the springs in the State Reservation was given to the newly-created Saratoga Springs Commission. In 1933, the Commission leased the springs' facilities and delegated their management to the Saratoga Springs Authority, a public benefit corporation of New York.

During the years 1932 to 1934, for which the tax is asserted, the Commission and the Authority operated the Reservation as a health resort and spa. There are recreation facilities, bath houses, drink halls, a research laboratory, and other buildings on the grounds. Some of the mineral waters of the springs that have a medicinal value are bottled and sold to distributors, retailers, and directly to consumers. The sales are promoted by advertising and customarily yield a profit which is applied to meeting in part the expenses of operating the other facilities. The remainder of those expenses is met by annual legislative appropriations.

different from preceding cases. The argument pressed by New York and the forty-five other States who, as amici curiae, have joined her deserves an answer.

Enactments levying taxes made in pursuance of the Constitution are, as other laws are, "the supreme Law of the Land." The first of the powers conferred upon Congress is the power "To lay and collect Taxes, Duties, Imposts and Excises * * *." Art. I, section 8. By its terms the Constitution has placed only one limitation upon this power, other than limitations upon methods of laying taxes not here relevant: Congress can lay no tax "on Articles exported from any State." Art. I, section 9. Barring only exports, the power of Congress to tax "reaches every subject." But the fact that ours is a federal constitutional system, as expressly recognized in the Tenth Amendment, carries with it implications regarding the taxing power as in other aspects of government. Thus, for Congress to tax State activities while leaving untaxed the same activities pursued by private persons would do violence to the presuppositions derived from the fact that we are a Nation composed of States.

But the fear that one government may cripple or obstruct the operations of the other early led to the assumption that there was a reciprocal immunity of the instrumentalities of each from taxation by the other. It was assumed that there was an equivalence in the implications of taxation by a State of the governmental activities of the National Government and the taxation by the National Government of State instrumentalities. This assumed equivalence was nourished by the phrase of Chief Justice Marshall that "the power to tax involves the power to destroy." McCulloch *v.* Maryland, 4 Wheat. 316, 431, 4 L. Ed. 579. To be sure, it was uttered in connection with a tax of Maryland which plainly discriminated against the use by the United States of the Bank of the United States as one of its instruments. What he said may not have been irrelevant in its setting. But Chief Justice Marshall spoke at a time when social complexities did not so clearly reveal as now the practical limitations of a rhetorical absolute. The phrase was seized upon as the basis of a broad doctrine of intergovernmental immunity, while at the same time an expansive scope was given to what were deemed to be "instrumentalities of the government" for purposes of tax immunity. As a result, immunity was until recently accorded to all officers of one government from taxation by the other, and it was further assumed that the economic burden of a tax on any interest derived from a government imposes a burden on that government so as to involve an interference by the taxing government with the functioning of the other government. See Metcalf & Eddy *v.* Mitchell, 269 U.S. 514, 46 S. Ct. 172, 70 L. Ed. 384; Helvering *v.* Mountain Producers Corporation, 303 U.S. 376, 58 S. Ct. 623, 82 L. Ed. 907; Graves *v.* People of State of New York ex rel. O'Keefe, 306 U.S. 466, 480, 481, 59 S. Ct. 595, 598, 599, 83 L. Ed. 927, 120 A.L.R. 1466.

To press a juristic principle designed for the practical affairs of government to abstract extremes is neither sound logic nor good sense. And this Court is under no duty to make law less than sound logic and good sense. When this Court for the

first time relieved State officers from a non-discriminatory Congressional tax, not because of anything said in the Constitution but because of the supposed implications of our federal system, Mr. Justice Bradley pointed out the invalidity of the notion of reciprocal intergovernmental immunity. The considerations bearing upon taxation by the States of activities or agencies of the federal government are not correlative with the considerations bearing upon federal taxation of State agencies or activities. The federal government is the government of all the States, and all the States share in the legislative process by which a tax of general applicability is laid. "The taxation by the State governments of the instruments employed by the general government in the exercise of its powers," said Mr. Justice Bradley, "is a very different thing. Such taxation involves an interference with the powers of a government in which other States and their citizens are equally interested with the State which imposes the taxation." [3] Since then we have moved away from the theoretical assumption that the National Government is burdened if its functionaries, like other citizens, pay for the upkeep of their State governments, and we have denied the implied constitutional immunity of federal officials from State taxes. Graves *v.* People of State of New York ex rel. O'Keefe, supra.

In the meantime, cases came here, as we have already noted, in which States claimed immunity from a federal tax imposed generally on enterprises in which the State itself was

[3] The views of Mr. Justice Bradley have been so vindicated by time and experience that his whole compact opinion deserves to be recalled:

"I dissent from the opinion of the court in this case, because, it seems to me that the general government has the same power of taxing the income of officers of the State governments as it has of taxing that of its own officers. It is the common government of all alike; and every citizen is presumed to trust his own government in the matter of taxation. No man ceases to be a citizen of the United States by being an officer under the State government. I cannot accede to the doctrine that the general government is to be regarded as in any sense foreign or antagonistic to the State governments, their officers, or people; nor can I agree that a presumption can be admitted that the general government will act in a manner hostile to the existence or functions of the State governments, which are constituent parts of the system or body politic forming the basis on which the general government is founded. The taxation by the State governments of the instruments employed by the general government in the exercise of its powers, is a very different thing. Such taxation involves an interference with the powers of a government in which other States and their citizens are equally interested with the State which imposes the taxation. In my judgment, the limitation of the power of taxation in the general government, which the present decision establishes, will be found very difficult of control. Where are we to stop in enumerating the functions of the State governments which will be interfered with by Federal taxation? If a State incorporates a railroad to carry out its purposes of internal improvement, or a bank to aid its financial arrangements, reserving, perhaps, a percentage on the stock or profits, for the supply of its own treasury, will the bonds or stock of such an institution be free from Federal taxation? How can we now tell what the effect of this decision will be? I cannot but regard it as founded on a fallacy, and that it will lead to mischievous consequences. I am as much opposed as any one can be to any interference by the general government with the just powers of the State governments. But no concession of any of the just powers of the general government can easily be recalled. I, therefore, consider it my duty to at least record my dissent when such concession appears to be made. An extended discussion of the subject would answer no useful purpose." Collector *v.* Day, 11 Wall. 113, 128, 129, 20 L. Ed. 122.

also engaged. This problem did not arise before the present century, partly because State trading did not actively emerge until relatively recently, and partly because of the narrow scope of federal taxation. In State of South Carolina *v.* United States, 199 U.S. 437, 26 S. Ct. 110, 50 L. Ed. 261, 4 Ann. Cas. 737, immunity from a federal tax on a dispensary system, whereby South Carolina monopolized the sale of intoxicating liquors, was denied by drawing a line between taxation of the historically recognized governmental functions of a State, and business engaged in by a State of a kind which theretofore had been pursued by private enterprise. The power of the federal government thus to tax a liquor business conducted by the State was derived from an appeal to the Constitution "in the light of conditions surrounding at the time of its adoption." That there is a Constitutional line between the State as government and the State as trader, was still more recently made the basis of a decision sustaining a liquor tax against Ohio. "If a state chooses to go into the business of buying and selling commodities, its right to do so may be conceded so far as the Federal Constitution is concerned; but the exercise of the right is not the performance of a governmental function. * * * When a state enters the market place seeking customers it divests itself of its quasi sovereignty pro tanto, and takes on the character of a trader, so far, at least, as the taxing power of the federal government is concerned." State of Ohio *v.* Helvering, supra, 292 U.S. at page 369, 54 S. Ct. at page 726, 78 L. Ed. 1307. When the Ohio case was decided it was too late in the day not to recognize the vast extension of the sphere of government, both State and national, compared with that with which the Fathers were familiar. It could hardly remain a satisfactory constitutional doctrine that only such State activities are immune from federal taxation as were engaged in by the States in 1787. Such a static concept of government denies its essential nature. "The science of government is the most abstruse of all sciences; if, indeed, that can be called a science, which has but few fixed principles, and practically consists in little more than the exercise of a sound discretion, applied to the exigencies of the state as they arise. It is the science of experiment." Anderson *v.* Dunn, 6 Wheat. 204, 226, 5 L. Ed. 242.

When this Court came to sustain the federal taxing power upon a transportation system operated by a State, it did so in ways familiar in developing the law from precedent to precedent. It edged away from reliance on a sharp distinction between the "governmental" and the "trading" activities of a State, by denying immunity from federal taxation to a State when it "is undertaking a business enterprise of a sort that is normally within the reach of the federal taxing power and is distinct from the usual governmental functions that are immune from federal taxation in order to safeguard the necessary independence of the state." Helvering *v.* Powers, supra, 293 U.S. at page 227, 55 S. Ct. at page 174, 79 L. Ed. 291. But this likewise does not furnish a satisfactory guide for dealing with such a practical problem as the constitutional power of the United States over State activities. To rest the federal taxing power on what is "normally" conducted by private enter-

prise in contradiction to the "usual" governmental functions is too shifting a basis for determining constitutional power and too entangled in expediency to serve as a dependable legal criterion. The essential nature of the problem cannot be hidden by an attempt to separate manifestations of indivisible governmental powers. See Wambaugh, Present Scope of Government (1897) 20 A.B.A. Rep. 307; Frankfurter, The Public and its Government (1930).

The present case illustrates the sterility of such an attempt.[4] New York urges that in the use it is making of Saratoga Springs it is engaged in the disposition of its natural resources. And so it is. But in doing so it is engaged in an enterprise in which the State sells mineral waters in competition with private waters, the sale of which Congress has found necessary to tap as a source of revenue for carrying on the National Government. To say that the States cannot be taxed for enterprises generally pursued, like the sale of mineral water, because it is somewhat connected with a State's conversation policy, is to invoke an irrelevance to the federal taxing power. Liquor control by a State certainly concerns the most important of a State's natural resources—the health and well-being of its people. If in its wisdom a State engages in the liquor business and may be taxed by Congress as others engaged in the liquor business are taxed, so also Congress may tax the States when they go into the business of bottling water as others in the mineral water business are taxed even though a State's sale of its mineral waters has relation to its conservation policy.

In the older cases, the emphasis was on immunity from taxation. The whole tendency of recent cases reveals a shift in emphasis to that of limitation upon immunity. They also indicate an awareness of the limited rôle of courts in assessing the relative weight of the factors upon which immunity is based. Any implied limitation upon the supremacy of the federal power to levy a tax like that now before us, in the absence of discrimination against State activities, brings fiscal and political factors into play. The problem cannot escape issues that do not lend themselves to judgment by criteria and methods of reasoning that are within the professional training and special competence of judges. Indeed the claim of implied immunity by States from federal taxation raises questions not wholly unlike provisions of the Constitution, such as that of Art. IV, section 4, guaranteeing States a republican form of government, see Pacific States Tel. & T. Co. *v.* State of Oregon, 223 U.S. 118, 32 S. Ct. 224, 56 L. Ed. 377, which this Court has deemed not within its duty to adjudicate.

We have already held that by engaging in the railroad business a State cannot withdraw the railroad from the power of the federal government to regulate commerce. United States *v.* State of California, 297 U.S. 175, 56 S. Ct. 421, 80 L. Ed. 567. Surely the power of Congress to lay taxes has impliedly no less a reach than the power of Congress to regulate commerce. There are, of course, State activities and State-owned property that partake of

[4] This method of solving a problem inherent in a federal constitutional system has been found equally inconclusive in Latin America. See S. P. Amadeo, *Argentine Constitutional Law* (New York: Columbia University Press, 1943), 97–103.

uniqueness from the point of view of intergovernmental relations. These inherently constitute a class by themselves. Only a State can own a Statehouse; only a State can get income by taxing. These could not be included for purposes of federal taxation in any abstract category of taxpayers without taxing the State as a State. But so long as Congress generally taps a source of revenue by whomsoever earned and not uniquely capable of being earned only by a State, the Constitution of the United States does not forbid it merely because its incidence falls also on a State. If Congress desires, it may of course leave untaxed enterprises pursued by States for the public good while it taxes like enterprises organized for private ends. If Congress makes no such differentiation and, as in this case, taxes all vendors of mineral water alike, whether State vendors or private vendors, it simply says, in effect, to a State: "You may carry out your own notions of social policy in engaging in what is called business, but you must pay your share in having a nation which enables you to pursue your policy." After all, the representatives of all the States, having, as the appearance of the Attorneys General of forty-six States at the bar of this Court shows, common interests, alone can pass such a taxing measure and they alone in their wisdom can grant or withhold immunity from federal taxation of such State activities.

The process of Constitutional adjudication does not thrive on conjuring up horrible possibilities that never happen in the real world and devising doctrines sufficiently comprehensive in detail to cover the remotest contingency. Nor need we go beyond what is required for a reasoned disposition of the kind of controversy now before the Court. The restriction upon States not to make laws that discriminate against interstate commerce is a vital constitutional principle, even though "discrimination" is not a code of specifics but a continuous process of application. So we decide enough when we reject limitations upon the taxing power of Congress derived from such untenable criteria as "proprietary" against "governmental" activities of the States, or historically sanctioned activities of Government or activities conducted merely for profit,[5] and

[5] Attempts along similar lines to solve kindred problems arising under the Canadian and Australian Constitutions have also proved a barren process. See Pond, "Intergovernmental Immunity: A Comparative Study of the Federal System," *Iowa L. Rev.* XXVI (1941), 272; Kennedy and Wells, *The Law of the Taxing Power in Canada* (1931), pp. 35–37.

Even where the Constitution of a Federal system explicitly deals with the problem of intergovernmental taxation, as in Brazil, litigation is not escaped and nice distinctions have to be made. See cases arising under Article 10 of the Constitution of 1891 and under Article 32 of the Constitution of 1937: Appelação civel, No. 2.884, 13 Rivesta do Supremo Tribunal 203 (1917); Appelação civel, No. 2.900, 14 Rivesta do Supreme Tribunal 44 (1918); Appelação civel, No. 536, 19 Revista do Suprema Tribunal 76 (1919); Recuso de mandado de segurança No. 617, 56 Archivo Judiciario 3 (1940); Agravo de petição, No. 8.024, 59 Archivo Judiciario 85 (1941). Article 32 of the Constitution of 1937, the present Brazilian Constitution, provides: "The Union, the States, and the Municipalities are forbidden: * * * a) to tax goods, income, or services of each other." Speaking of the earlier Constitution, a commentator notes: "These limitations on the federal taxing power are all taken from our own jurisprudence, either by direct transcription from the Constitution of the United States or by the incorporation of principles laid down in decisions of our [the United States] supreme court, as is the

find no restriction upon Congress to include the States in levying a tax exacted equally from private persons upon the same subject matter.

Judgment affirmed.

* * * *

Mr. Justice DOUGLAS, with whom Mr. Justice BLACK concurs, dissenting.

I

If State of South Carolina *v.* United States, 199 U.S. 437, 26 S. Ct. 110, 50 L. Ed. 261, 4 Ann. Cas. 737, is to stand, the present judgment would have to be affirmed. For I agree that there is no essential difference between a federal tax on South Carolina's liquor business and a federal tax on New York's mineral water business. Whether State of South Carolina *v.* United States reaches the right result is another matter.

Mr. Justice Brandeis stated that "Stare decisis is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right." Burnet *v.* Coronado Oil & Gas Co., 285 U.S. 393, 406, 52 S. Ct. 443, 447, 76 L. Ed. 815. But throughout the history of the Court stare decisis has had only a limited application in the field of constitutional law. And it is a wise policy which largely restricts it to those areas of the law where correction can be had by legislation. Otherwise the Constitution loses the flexibility necessary if it is to serve the needs of successive generations.

I do not believe State of South Carolina *v.* United States states the correct rule. A State's project is as much a legitimate governmental activity whether it is traditional, or akin to private enterprise, or conducted for profit. Cf. Helvering *v.* Gerhardt, 304 U.S. 405, 426, 427, 58 S. Ct. 969, 978, 979, 82 L. Ed. 1427. A State may deem it as essential to its economy that it own and operate a railroad, a mill, or an irrigation system as it does to own and operate bridges, street lights, or a sewage disposal plant. What might have been viewed in an earlier day as an improvident or even dangerous extension of state activities may today be deemed indispensable. But as Mr. Justice White said in his dissent in State of South Carolina *v.* United States, any activity in which a State engages within the limits of its police power is a legitimate governmental activity. Here a State is disposing of some of its natural resources. Tomorrow it may issue securities, sell power from its public power project, or manufacture fertilizer. Each is an exercise of its power of sovereignty. Must it pay the federal government for the privilege of exercising that inherent power? If the Constitution grants it immunity from a tax on the issuance of securities, on what grounds can it be forced to pay a tax when it sells power or disposes of other natural resources?

II

One view, just announced, purports to reject the distinction which State of South Carolina *v.* United States drew between those activities of a State which are and those which are not strictly governmental, usual, or traditional. But it is said that a federal tax on a State will be sustained so long as Congress "does not

case with the last named prohibition"—"the prohibition against taxing property, revenues, or services of the States." James, *Federal Basis of the Brazilian System* (1923), p. 45.

attempt to tax a State because it is a State." Yet if that means that a federal real estate tax of general application (apportioned) would be valid if applied to a power dam owned by a state but invalid if applied to a statehouse, the old doctrine has merely been poured into a new container. If, on the other hand, any federal tax on any state activity were sustained unless it discriminated against the State, then a constitutional rule would be fashioned which would undermine the sovereignty of the States as it has been understood throughout our history. Any such change should be accomplished only by constitutional amendment. The doctrine of state immunity is too intricately involved in projects which have been launched to be whittled down by judicial fiat.

III

Woodrow Wilson stated the starting point for me when he said [6] that "the States of course possess every power that government has ever anywhere exercised, except only those powers which their own constitutions or the Constitution of the United States explicitly or by plain inference withhold. They are the ordinary governments of the country; the federal government is its instrument only for particular purposes." The Supremacy Clause, Article VI, clause 2, applies to federal laws within the powers delegated to Congress by the States. But it is antagonistic to the very implications of our federal system to say that the power of Congress to lay and collect taxes, Article 1, section 8, includes the power to tax any state activity or function so long as the tax does not discriminate against the States.[7] As stated in United States *v.* Railroad Co., 17 Wall. 322, 327, 328, 21 L. Ed. 597:

> The right of the States to administer their own affairs through their legislative, executive, and judicial departments, in their own manner through their own agencies, is conceded by the uniform decisions of this court and by the practice of the Federal government from its organization. This carries with it an exemption of those agencies and instruments, from the taxing power of the Federal government. If they may be taxed lightly, they may be taxed heavily; if justly, oppressively. Their operation may be impeded and may be destroyed, if any interference is permitted.

Can it be that a general federal tax on the issuance of securities would be constitutional if applied to the issuance of municipal securities or of state bonds or of the securities of public utility districts organized by the States? Could the States be classified with farmers, business men, industrial workers, judges and other ordinary citizens and required to pay an income tax to the federal government? It is said that a federal income tax on the tax revenues of a State would not be sustained because such a tax would interfere with a sover-

[6] *Constitutional Government in the United States* (1908), pp. 183, 184.

[7] As stated in United States *v.* State of California, 297 U.S. 175, 184, 185, 56 S. Ct. 421, 424, 425, 80 L. Ed. 567, the immunity of state instrumentalities from federal taxation "is implied from the nature of our federal system and the relationship within it of state and national governments, and is equally a restriction on taxation by either of the instrumentalities of the other." It went on to say in justification of making state activities subject to the exercise by Congress of the commerce power, "But there is no such limitation upon the plenary power to regulate commerce. The state can no more deny the power if its exercise has been authorized by Congress than can an individual."

eign function of the State. But can it be that a federal income tax on state revenues derived not from taxes but from the sale of mineral water, liquor, lumber and the like, would be sustained?

A tax is a powerful, regulatory instrument. Local government in this free land does not exist for itself. The fact that local government may enter the domain of private enterprise and operate a project for profit does not put it in the class of private business enterprise for tax purposes. Local government exists to provide for the welfare of its people, not for a limited group of stockholders. If the federal government can place the local governments on its tax collector's list, their capacity to serve the needs of their citizens is at once hampered or curtailed. The field of federal excise taxation alone is practically without limits. Many state activities are in marginal enterprises where private capital refuses to venture. Add to the cost of these projects a federal tax and the social program may be destroyed before it can be launched. In any case, the repercussions of such a fundamental change on the credit of the States and on their programs to take care of the needy and to build for the future would be considerable. To say the present tax will be sustained because it does not impair the State's functions of government is to conclude either that the sale by the State of its mineral water is not a function of government or that the present tax is so slight as to be no burden. The former obviously is not true. The latter overlooks the fact that the power to tax lightly is the power to tax severely. The power to tax is indeed one of the most effective forms of regulation. And no more powerful instrument for centralization of government could be devised. For with the federal government immune and the States subject to tax, the economic ability of the federal government to expand its activities at the expense of the States is at once apparent. That is the result whether the rule of State of South Carolina *v.* United States be perpetuated or a new rule of discrimination be adopted.

The notion that the sovereign position of the States must find its protection in the will of a transient majority of Congress is foreign to and a negation of our constitutional system. There will often be vital regional interests represented by no majority in Congress. The Constitution was designed to keep the balance between the States and the nation outside the field of legislative controversy.

The immunity of the States from federal taxation is no less clear because it is implied. The States on entering the Union surrendered some of their sovereignty. It was further curtailed as various Amendments were adopted. But the Tenth Amendment provides that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." The Constitution is a compact between sovereigns. The power of one sovereign to tax another is an innovation so startling as to require explicit authority if it is to be allowed. If the power of the federal government to tax the States is conceded, the reserved power of the States guaranteed by the Tenth Amendment does not give them the independence which they have always been assumed to have. They

are relegated to a more servile status. They become subject to interference and control both in the functions which they exercise and the methods which they employ. They must pay the federal government for the privilege of exercising the powers of sovereignty guaranteed them by the Constitution,[8] whether, as here, they are disposing of their natural resources, or tomorrow they issue securities or perform any other acts within the scope of their police power.

Of course, the levying of the present tax does not curtail the business of the state government more than it does the like business of the citizen. But the same might be true in the case of many state activities which have long been assumed to be immune from federal taxation. When a municipality acquires a water system or an electric power plant and transmission facilities, it withdraws projects from the field of private enterprise. Is the tax immunity to be denied because a tax on the municipality would not curtail the municipality more than it would the prior private owner? Is the municipality to be taxed whenever it engages in an activity which once was in the field of private enterprise and therefore was once taxable? Every expansion of state activity since the adoption of the Constitution limits the reach of federal taxation if state immunity is recognized. Yet none would concede that the sovereign powers of the States were limited to those which they exercised in 1787. Nor can it be said that if the present tax is not sustained there will be withdrawn from the taxing power of the federal government a subject of taxation which has been traditionally within that power from the beginning. Not until State of South Carolina *v.* United States was it held that so-called business activities of a State were subject to federal taxation. That was after the turn of the present century. Thus the major objection to the suggested test is that it disregards the Tenth Amendment, places the sovereign States on the same plane as private citizens, and makes the sovereign States pay the federal government for the privilege of exercising the powers of sovereignty guaranteed them by the Constitution.

That this idea is hostile to the view of the Framers of the Constitution is evident from Hamilton's discussion of the taxing power of the federal government in The Federalist, Nos. 30–36 (Sesquicentennial Ed. 1937) pp. 183–224. He repeatedly stated that the taxing powers of the States and of the federal government were to be "concurrent"—"the only admissible substitute for an entire subordination, in respect to this

[8] That fact distinguishes those cases where a citizen seeks tax immunity because his income was derived from a State or the federal government. Recognition of such a claim would create a "privileged class of taxpayers" (Helvering *v.* Gerhardt, supra, 304 U.S. at page 416, 58 S. Ct. at page 973, 82 L. Ed. 1427) and extend the tax immunity of the States or the federal government to private citizens. It was in protest to the recognition of such a derivative immunity that Mr. Justice Bradley dissented in Collector *v.* Day, 11 Wall. 113, 128, 20 L. Ed. 122, where the Court held unconstitutional a federal tax on the salary of a judicial officer of a State. As Mr. Justice Bradley stated, "No man ceases to be a citizen of the United States by being an officer under the State government." 11 Wall. at page 128, 20 L. Ed. 122. And see Graves *v.* People of State of New York ex rel. O'Keefe, 306 U.S. 466, 59 S. Ct. 595, 83 L. Ed. 927, 120 A.L.R. 1466, holding that salaries of federal employees may be constitutionally included in a nondiscriminatory state income tax.

branch of power, of the State authority to that of the Union." Pp. 202, 203. He also stated, "The convention thought the concurrent jurisdiction preferable to that subordination; and it is evident that it has at least the merit of reconciling an indefinite constitutional power of taxation in the Federal government with an adequate and independent power in the States to provide for their own necessities." P. 209. On such assurances could it possibly be thought that the States were so subordinate that their activities could be taxed by the federal government?

In McCulloch *v.* Maryland, 4 Wheat. 316, 4 L. Ed. 579, the Court held unconstitutional a state tax on notes of the Bank of the United States. The statement of Chief Justice Marshall (4 Wheat. at pages 429, 430, 4 L. Ed. 579) is adequate to sustain the case for the reciprocal immunity of the state and federal governments:

> If we measure the power of taxation residing in a State, by the extent of sovereignty which the people of a single State possess, and can confer on its government, we have an intelligible standard, applicable to every case to which the power may be applied. We have a principle which leaves the power of taxing the people and property of a State unimpaired; which leaves to a State the command of all its resources, and which places beyond its reach, all those powers which are conferred by the people of the United States on the government of the Union, and all those means which are given for the purpose of carrying those powers into execution. We have a principle which is safe for the States, and safe for the Union. We are relieved, as we ought to be, from clashing sovereignty; from interfering powers; from a repugnancy between a right in one government to pull down what there is an acknowledged right in another to build up; from the incompatibility of a right in one government to destroy what there is a right in another to preserve. We are not driven to the perplexing inquiry, so unfit for the judicial department, what degree of taxation is the legitimate use, and what degree may amount to the abuse of the power.

IV

Those who agreed with State of South Carolina *v.* United States had the fear that an expanding program of state activity would dry up sources of federal revenues and thus cripple the national government. That was in 1905.[9] That fear is expressed again today when we have the federal income tax, from which employees of the States may not claim exemption on constitutional grounds. Helvering *v.* Gerhardt, supra. The fear of depriving the national government of revenue if the tax immunity of the States is sustained has no more place in the present decision than the spectre of socialism, the fear of which, said Holmes "was translated into doctrines that had no proper place in the Constitution or the common law."[10]

There is no showing whatsoever that an expanding field of state activity even faintly promises to cripple the federal government in its search for needed revenues. If the truth were known, I suspect it would show that the activity of the States

[9] As the Solicitor General of New York points out, in the year when South Carolina *v.* United States was decided over one-fourth of the entire annual income of the federal government was derived from taxes on spirits and fermented liquors. See Annual Report, Secretary of the Treasury (1905), pp. 7, 26.

[10] Holmes, *Collected Legal Papers* (1921) p. 295.

in the fields of housing, public power and the like have increased the level of income of the people and have raised the standards of marginal or sub-marginal groups. Such conditions affect favorably, not adversely, the tax potential of the federal government.

86

HENRY SIMONS

Tax-Exempt Securities

IMMUNITY of governmental instrumentalities from taxation has led to the "tax-exempt security" problem. This involves economic and equity as well as legal aspects. The former are discussed by Professor Henry Simons in the following selection: *

Any exemption of receipts by kind is clearly incompatible with the essential rationale of income taxes. The base of such taxes is properly a measure of the relative prosperity of individuals, and no data relevant to such measurement can be disregarded or excluded without distortion of the relative levies upon persons. We have noted, as a conspicuous fault of American legislation, the disregard of the net receipts from real property used by its owner for consumption purposes and, as a fault common to levies both here and abroad, the partial or complete exclusion of capital gains and losses. The neglect of gratuitous receipts is likewise anomalous and unfortunate. Most flagrant and least pardonable of all such errors of omission, however, is the exemption of the interest and salary payments of governmental bodies. The other omissions find some explanation, if only in terms of strange misconceptions; the relevant questions of policy are still controversial, whether they should be or not. But hardly anyone would pretend to justify the deliberate exemption of interest on governmental obligations; for any government which does this is violating its responsibility for levying personal taxes equitably.

Interest on the obligations of our states and their political subdivisions is entirely exempt from federal income tax, by statute (sec. 22*b* [4]), and is generally held to be exempt on constitutional grounds.[1] Amounts

[1] Some authorities (Corwin, notably) have questioned this view. The position commonly imputed to the Court certainly has

* Reprinted by permission from *Personal Income Taxation,* University of Chicago Press, 1938, pp. 170–183.

received as compensation for services rendered to such governmental units by their officials and regular employes are likewise exempt.[2] Other similar exemptions are a matter of deliberate action by Congress, or by the treasury under discretionary powers granted by Congress to the secretary. One small issue of Liberty Bonds carried complete exemption; other issues carried strange partial exemptions of a varied and complicated nature. Secretary Mellon (after urging amendment to abolish all exemptions) inaugurated a policy of issuing short-term obligations with full exemption (to enable the treasury to compete with the states and municipalities!). This policy has bloomed in fuller ugliness under Mr. Morgenthau, whose advisors and assistants evidently have felt that any means was justified in the flotation of short-term issues at spectacularly low rates of yield. Supreme among the extant fiscal monstrosities, however, is the grant of income-tax exemptions with respect to the bonds of federal corporations like the land banks, and joint-stock land banks. One might compile an engaging list of fiscal vagaries which owe their existence to that strange stigma which attaches to straightforward and explicit subsidies (in a nation where indirect tariff subsidies are innumerable and transparent); and this one might well head that list.

The exemption of salaries paid by our state and local governments is a minor (but thoroughly objectionable) kind of fault. The beneficiaries of this exemption will seldom have much other income, and government salaries rarely expose them to high rates of tax. A few people, to be sure, will be grossly undertaxed; but no important opportunities are created for deliberate evasion.

The exemption of the interest payments on an enormous amount of government bonds, on the other hand, is a flaw of major importance. It opens the way to deliberate avoidance on a grand scale; and it provides a method of avoidance which must give rise to serious inequities and to some diseconomies. The method is not available to persons whose large incomes are derived from salaries and fees. It is not easily accessible to persons, active in the control and management of enterprises, whose investments cannot be diversified without loss of the desired control over their firms. Indeed, this device of avoidance is entirely attractive only to the idle, passive holders of highly conservative investments. Thus the exemption not only undermines the program of progressive personal taxation but also introduces a large measure of differentiation in favor of those whose role in our economy is merely that of *rentiers*.

The exemption, of course, carries a price. With strictly proportional

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little to commend it on logical grounds; but, after tacit acceptance for many years, it may now be regarded as properly amenable to change by the straightforward procedure of constitutional amendment—however inadequate the reasoning behind the position.

[2] This exemption, unlike that of interest, is a matter of administrative ruling, not of statute—although the Act of 1926 (sec. 1211) excluded such compensation under prior acts. The treasury has conferred the administrative exemption only with respect to compensation for services rendered in connection with the exercise of an essential governmental function (a nice distinction!), thus leaving the salary payments of municipal utilities subject to tax. The definition of "officer or employee" also limits the exemption quite narrowly. See *Regulations* 86, pp. 212–13.

levies, the yield differential attributable to the exemption would probably reflect its full value to all purchasers. With progressive rates, however, a fully compensating yield differential is impossible, unless the exempt obligations are very scarce and are held entirely by persons paying the maximum rates of surtax. Even in these circumstances there will be unfortunate windfalls of gain or loss whenever the rates of tax are changed in a manner which the market has not anticipated fully. Thus, the holders of our state and local obligations were greatly benefited by the rapid development of our federal income tax—while the debtor agencies gained only with respect to their new borrowings.[3]

Actually, tax-exempt securities are abundant; and they are not held even mainly by persons subject to the highest surtaxes. The yield differential reflects the value of exemption only to the so-called middle-income groups—or to persons of large income for whom investment in "tax exempts" involves large disadvantages or "disutilities." Most taxpayers cannot afford the exemption at all; some would only break even; but the *rentier* of great wealth finds here a tremendous bargain. Here, at last, is a "commodity" with respect to which the traditional and naive conception of "consumer surplus" has clear meaning and significance. The value of additional increments of exemption to him will show continued (if not continuous) decline; but the value of the early increments remains precisely the same, however many increments are added; and a summation of the incremental values measures properly the value of his "stock." And it is precisely this "consumer surplus" which reflects the folly of the exemption.

Professor Hardy, after interesting analysis of a mass of data, came to the conclusion that the practice of exemption actually worked out profitably, for all our taxing and borrowing agencies together, up to 1924.[4] The inadequacies of his method for determining the yield differential, to be sure, all eased the way to this startling conclusion; but a more serious criticism is in order. Hardy appears to offer his statistical work as demonstrating that tax exemption, as a serious problem, is merely a creature of uninformed minds. The author never says this, to be sure; but the tone of the book is such that failure to disavow the implication is equivalent to assertion of the position. Let us concede that all governmental units together were coming out about even with respect to the tax-exempt securities. (In view of the bias in his methods, this is a gener-

[3] It is an interesting anomaly that, despite the Sixteenth Amendment, our federal government, in order to impose or increase its personal taxes, must contribute heavily toward the costs of state and local borrowing. The powers reserved to the states, of course, must not be impaired. It seems a weird kind of rhetorical legerdemain, however, which finds in this principle both a prohibition against the equitable imposition of personal taxes and the requirement of large and curious subsidies to the states as payment for the limited exercise of a prerogative which has been granted to the federal government specifically and unreservedly.

[4] C. O. Hardy, *Tax Exempt Securities and the Surtax* (New York, 1926), esp. Chap. 4. The only evident flaw in his statistical analysis (but a very serious one) lies in his obviously biased method for calculating the yield differential. For other calculations, similar in their methods and in their results, see Hinrichs, "The Cost of Tax Exempt Securities," *Political Science Quarterly*, XLI (1926), 271–80.

ously small amendment of Hardy's actual results.) What now would be the significance of such a fact for the question of policy?

The essential point here has to do with the "maximum-revenue criterion." Its shortcomings, as a guide for policy in personal taxation, have been noted in previous chapters; and they are not less great in this instance than in others. The problem of tax-exempt securities is perhaps largely illusory, *unless* one happens to be interested in the income tax as a means for reaching persons equitably and progressively; but from that viewpoint it is terribly real.[5]

The government will not lose heavily in the case of all large taxpayers. Many of them will find it impossible, unprofitable, or unattractive to convert their incomes into a tax-exempt form. An individual may be unwilling to abandon control of enterprises which have been largely his own; he may be able to obtain a much larger income by combining his investments with active participation in management; or he may greatly prefer the active business role which concentration of his investment permits, even with small or negligible remuneration for his services. But the avoidance of revenue losses in the case of such persons means a most inequitable distribution of tax burdens as between them and others of similar income circumstances. Broadly speaking, it means gross differentiation within the upper brackets in favor of coupon clippers and against those actively engaged in business enterprise—which hardly commends the arrangement!

In any case, there will certainly be a heavy net loss with respect to persons of great wealth; the governments can only lose in the case of persons who acquire the securities for the exemption. Where, then, could there be gains to offset this loss? The answer must lie in a highly inelastic demand for exempt securities on the part of other purchasers; and these other purchasers, obviously, are corporations and individuals not subject to high surtax rates. The inelasticity of their demand may be attributed (*a*) to the nature and traditions of certain businesses and to legal requirements regarding the investments of financial corporations and (*b*) to the disposition of many thrifty persons to buy governmental obligations almost regardless of yield. The lower yields resulting from the valuable exemption can have but limited effect on the portfolios of life insurance companies, of savings banks, and of ordinary people who distrust, as regards other investments, both their own judgment and the kind of advice available to them.

Thus, if governments did break even on the exemption practice, they could do so only by forcing a lower rate of return upon intramarginal buyers of government bonds—i.e., only if those who purchase for the exemption force down the yields without altering greatly the amount

[5] Hardy conceded this point as soon as it was raised against his book, by the present writer and by others previously. Our criticism is directed against a position which his book implies, not against one which he actually holds. Moreover, the book itself, in spite of minor faults which we have noted, was an important and substantial contribution. It was abundantly informing; it exposed clearly the arrant sophistries of Mr. Mellon; and it discredited the statistical extravagances of writers like Seligman, whose sound enthusiasm for abolition of the exemptions had led them into unsound argument, careless assertions, and essentially irrelevant discussion.

of exempt securities held by persons and institutions to whom the exemption has little or no value. Those who purchase for the exemption may greatly reduce their tax payments; but their purchases will permit the marketing of new issues at lower rates of yield. Those who lose by the arrangement are the conservative investors of small means and the financial institutions which serve largely the middle- and lower-income groups. The exemption practice is thus doubly regressive in its burden: it compels recourse to excises for revenues which would otherwise have come from persons of large means and, for people of small means, it lowers the return on their investments and increases the costs of insurance and annuities.

The whole policy of exemption works out like a subsidy, distributed in the form of relief from surtaxes and financed by levies upon small savers. So, one may well reverse Hardy's implication and assert that the results of the policy would probably be less objectionable, on any reasonable welfare criteria, if it showed a heavy fiscal loss than if no loss or a gain were involved. Heavy loss would be indicative of a more uniform scaling-down of the burdens on persons of large income; while the absence of loss implies gross discrimination among such persons and a heavy regression burden on other groups as well.

The policy may also be interpreted as one of offering governmental obligations to different persons on widely different terms—as a strange sort of class-price policy in the sale of securities. If you are subject to the highest rates of surtax, you are offered, in effect, a return of about 12 per cent on your investments in state and local obligations; if your income does not expose you to federal income tax, you are offered about 3 per cent. One hardly need ask whether it would be desirable or politically possible to do openly and straightforwardly what is accomplished here by indirection—and by deliberate action as well as by errors of omission.

And other counts may be added to the indictment. The exemption, along with other faults of the law, enables us, and our political representatives especially, to enjoy all the moral satisfaction of imposing radical and drastic levies on great wealth without actually doing so. The discrimination against those who obtain large incomes from salaries, or by combining their investments with active participation in business, is deplorable, both on economic and on ethical grounds. The indirect subsidizing of the states and their subdivisions is thoroughly bad not in itself but because the subsidy is allocated in proportion to borrowing. Finally, the effects on our whole investment situation are exceedingly unfortunate. Those who should absorb the more speculative issues are forced into a kind of investment which should largely be reserved for those whose total investments are too small to permit real diversification or to support thorough investment analysis. Those who should buy nothing else are turned away from government bonds by their scarcity and low yield; and persons who, with their statisticians and professional analysts, should arbitrate the direction of new and speculative undertaking can now be attracted away from exempt investments only by prospects of fabulous yields. On all these scores, exemption does

things which would seem preposterous if done straightforwardly.

Our federal law has sought to avoid some anomalies by partial prohibition of the deduction of interest "on indebtedness incurred or continued to purchase or carry" tax-exempt securities (sec. 23*b*). The rationale of this provision is obvious enough. Suppose that a maximum rate of 75 per cent is levied with respect to personal income in excess of $10,000,000; and take the case of a person whose taxable income is consistently in excess of that amount. This individual borrows, let us say, $10,000,000 at 4 per cent, posting gilt-edge securities as collateral, and uses the proceeds of the loan to purchase 3 per cent municipal bonds at par. On the face of it, he loses $100,000 annually by such an operation; but the interest deduction would reduce his taxable income by $400,000 and reduce his tax payment by $300,000 annually. The operation thus would show a net profit of $200,000 after taxes.

While the law clearly prohibits this device of evasion, the prohibition is entirely ineffective. Congress may rest comfortable in the notion that it has dealt with the problem; actually, it has only laid down an ambiguous and unenforceable rule; for application of the rule requires determination of purpose or intention. How may the treasury or the courts determine whether particular debts are incurred or continued for the purpose of purchasing or carrying particular securities? Here again is the naive notion that particular items on the right-hand side of a balance sheet are represented by particular items on the left-hand side. Actually, the interest deduction is denied only in the case of collateral loans which are secured by the deposit of tax-exempt securities.[6] Thus, this device of avoidance is really prohibited only in the case of persons unable to provide other good collateral and unable to borrow without collateral—i.e., only in the case of persons of small means!

Secretary Mellon once proposed a revision of this section which would have made the prohibition what it now only seems to be. His excellent suggestion was that taxpayers be permitted to deduct as interest only the amount by which their interest expense exceeded their tax-exempt income.[7] Acting on this suggestion, Congress might have rescued section 23*b* from absurdity; but the appropriate legislation was not forthcoming. There were doubtless many misgivings on constitutional grounds. However, while the prohibition ought to be either made effective or repealed outright, there is clearly no important mitigation of the tax-exemption difficulty to be found along these lines. Moreover, Mr. Mellon's scheme is less attractive when one examines it more closely.

There is little reason why anyone should resort to these borrowing tricks, unless the costs involved in outright transfer of one's investments are unusually high. Why should anyone borrow to purchase "tax exempts" unless all his investments promise to yield a higher rate

[6] Where tax-exempt securities represent only part of the collateral, only a proportionate part of the interest on the loan is non-deductible. See Montgomery, *Federal Income Tax Handbook, 1936–37*, p. 497.

[7] Letter from the Secretary of the Treasury to the acting chairman of the Committee on Ways and Means, November 10, 1923. Reprinted in Mellon, *Taxation: The People's Business* (New York, 1924), Appen. A (see pp. 183–84).

of interest than that at which he can borrow? Looking at the matter in this light, one sees that the proposed legislation would not limit appreciably the opportunities for evasion, among persons subject to high rates, except in the case of those actively engaged in business. The limitation would be quite innocuous for persons whose property is largely in conservative and diversified investments and whose role in business is essentially passive. On the other hand, it would close this avenue of avoidance for persons unwilling to adopt that role and unable to diversify their commitments without undue loss of managerial control. On grounds of fairness among persons of large income, it may thus be argued that such backhanded and partial nullification of the exemptions might do more harm than good. If we are to offer large opportunities for evasion of high surtaxes, these opportunities should not be made available to people of similar incomes on more unequal and more unreasonably different terms. But, to repeat, the existing rule should either be implemented or repealed. The law is now overcrowded with empty, verbal solutions of totally unsolved problems.

There can be no satisfactory solution apart from the complete removal of the specific exemptions. An appropriate amendment to the Constitution has repeatedly been recommended to Congress in presidential messages. One may regret the necessity of amendment; and one may feel that it would be unwise now (1936) for intelligent conservatives to recommend even the most desirable constitutional changes; but the considerations in question are less important in a case like this one, where the question of policy is not controversial. The question of policy was settled by the adoption of the Sixteenth Amendment. There is now no real dispute as to whether the federal government should levy a tax upon persons according to their respective income circumstances. The exemption situation simply prohibits the equitable imposition of such a tax—prohibits indeed any adequate realization of the purposes implicit in the Sixteenth Amendment. Whether the blame lies with those who drafted the amendment or with the Court (or with the treasury and its legal counsel) is now perhaps an academic question.

The important problem now is that of inducing Congress to propose, and the states to ratify, an amendment which can have no intelligent opposition. As things stand, the borrowing states and their subdivisions do enjoy a substantial federal subsidy; and some opposition must arise against any measure which would both make our surtaxes more effective and increase the direct costs of state and local borrowing. The long-continued and deliberate inaction of Congress suggests the necessity of wise political maneuvering; and the situation admits of good measures for overcoming opposition based on the vested interests in the borrowing subsidy. At worst, the federal government might undertake, for a considerable period, to subsidize every state to the extent of, say, 1 per cent annually of its new bond issues (including those of its subdivisions). At best, Congress and the administration might promise a generous sharing of federal income-tax revenues with the states, as soon as the amendment was ratified. A division of revenues on the basis of col-

lections seems eminently desirable in itself (see below, chap. x); and it might wisely be held out as an inducement for the proposal and ratification of an amendment abolishing all the exemptions now seemingly required by the Constitution and the Court.

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HAROLD M. GROVES

Municipal Incentives to New Industries

CITIES and states may not protect industries with tariffs, but they do engage in industrial promotion through the use of tax and other financial favors. The editor has discussed this problem before a convention of city officials in the following selection: *

Those interested in municipal government have been sorely perplexed about the phenomenon of municipal incentives to new industries. Municipal practices in this field have often been condemned. But they persist, sometimes in spite of a clear mandate of law against them. Is there an economic justification for these incentives?

Are these incentives effective in securing and retaining new industries? There is some evidence suggesting that low taxes are probably less important as a motive for location of industry than is generally supposed.

In 1929 the 1927 income tax returns of Wisconsin metal manufacturing corporations were tabulated. The study showed a ratio of taxes to net income of 40.3 percent. This calculation included the corporations with losses as well as those with profits. The figure is impressively large. However, the ratio of taxes to the cost of manufacture was calculated to be 3.09 percent. The ratio of state and local taxes to the cost of manufacture was 1.65 percent. Of the 1.65 percent, by no means all could ever be escaped by a change of location. Assuming that half the burden could be wiped out by a change in location, this would represent eight-tenths of one percent of the cost of manufacture. If the wages of labor represent half the cost of manufacture, then a difference in wage levels of less than two percent should be more important to a corporation in choosing a location than any probable tax advantage which might be offered.

Several studies have sought by

* *The Municipality* (League of Wisconsin Municipalities), Jan. 1945.

questionnaires to determine from industrialists themselves why they chose a particular location or moved from one to another. A survey of 2,084 communities in the United States and Canada by the civic development committee of the National Electric Light Association and the policy holders' service bureau of the Metropolitan Life Insurance Company in 1926 and 1927 listed 16 major reasons for such choices. The most important were markets, labor, transportation, and materials. Taxation was placed twelfth on the list.

This evidence, of course, applies to the general run of industries. It may be less applicable to specific industries. Moreover, if the advantages of two locations are fairly evenly balanced, tax concessions may be sufficient to tip the scales. Certainly many city fathers think so.

Do inducements bring industries that are sufficiently suitable to their new environment to remain and prosper? New businesses are of little value unless they are well suited to the community which promotes them and have a reasonable prospect of taking root there. There would be little point in promoting steel manufacture in South Dakota or shipbuilding in Kentucky.

Some industries, called "hobo" industries, have had undesirable leadership and have specialized in very speculative ventures. These industries make a racket out of municipal inducements. Advantages granted to such concerns are likely to prove one-sided arrangements with the municipality getting the short end.

An example of a case of this kind and one involving an interesting court decision occurred recently in Wisconsin. A municipality borrowed $100,000 to give a bonus to a new industry and collected the money through public taxes. The industry agreed to provide a payroll of a million dollars over a ten-year period and offered a bond to secure its faithful performance. The company defaulted upon its contract and the municipality sued the surety company. The state supreme court[1] denied the right to collect on the bond. The court said the municipality's procedure was "permeated with illegality," that the contract was opposed to public policy and that to assist the municipality to collect would encourage dishonest transactions. While no study was made of the industry involved in this case, it seems highly probable that it was an exceedingly poor gamble from the standpoint of the municipality.

The customary advice to young people who are contemplating the selection of a life partner is that they use due discretion and do not make decisions on the spur of the moment under the moonlight. Similar advice might sometimes be given to municipal officials.

If municipalities are to embark upon industrial promotion programs, they ought to investigate their applicants with the same thoroughness required in good city planning generally.

Municipal incentives are largely a relative proposition and cease to become effective when all municipalities offer them. If one merchant keeps his store open on Sunday while others are closed, he can make money by so doing. But if all merchants follow the same policy, none of them are benefited. Similarly, if only one municipality were to offer special

[1] *Wendlandt* v. *Hartford Accident and Indemnity Co.,* 222 Wis. 204, 268 N.W. 230, 1936.

tax advantages, it could attract, perhaps, a considerable number of desirable industries, but when the favors are universalized they cease to be effective. Of course, one municipality can outdo another in its inducements. The question then arises as to when and where will the competition in subsidies stop.

How far these municipalities have gone in some instances can be observed in the following example of demands upon Augusta, Georgia, made by an industry in a neighboring state as a condition of relocation.[2]

> While we would prefer to have a new building designed particularly for our manufacturing requirements, we would be willing to entertain a proposition with you, providing that the city of Augusta would agree to do the following things, and make such concessions as are indicated herewith:
>
> 1. Without expense to us, repair and condition all buildings and property suitable to our requirements, a general outline of which is submitted as Schedule I attached. (This outline is contained in two and a half closely-typed pages.)
> 2. Without expense to us, widen and put in usable condition existing roadways approaching to front and rear of property.
> 3. Furnish railroad siding without expense to us.
> 4. Furnish water power free of cost to us for a period of ten years.
> 5. Furnish water from city mains free to us for a period of ten years.
> 6. Relieve us of all city taxes for a period of five years.
> 7. Establish reasonable basis of assessment upon which taxes will be established after five years.
> 8. Reimburse us for expense occasioned by and incidental to dismantling fixtures and equipment at present location; to moving said machinery, fixtures, and equipment and supplementary factory utensils to Augusta, Ga.; and to the installation of all machinery, fixtures and equipment at factory in Augusta. It is understood that the aggregate amount paid us for such purposes should not exceed $5,000.
> 9. The city and/or state to agree to pay 50 percent of the cost of training operators.
> 10. The city of Augusta to use its best efforts with the Post Office Department to establish a post office address to be known as Sutherland, Ga. (This was the name of the old factory site.)
> 11. The city of Augusta agrees to permit us to occupy said Sutherland building and properties for a period of ten years, or until such time as we have paid $1,500,000 in wages to employees engaged at the Sutherland plant, and such occupancy to be without expense to us as tenants or otherwise.
> 12. At such date as we have paid $1,500,000 in wages to employees at the Sutherland plant, we are to receive full title to the buildings, property and water rights and privileges that are connected with the Sutherland plant.
> 13. City of Augusta to cooperate with us in establishing beneficial commodity rates.

Augusta went a long way toward meeting these demands but not far enough to satisfy the industry.

Municipalities need to consider both sides of the balance sheet when deciding upon special inducements. New industries may involve not only tax concessions but also a large amount of additional public expenditure, particularly if a new labor supply must be imported. Highly developed industrial cities do not always have low tax rates. Large cities usually have a larger per capita expense than small ones. Size is not always

[2] Cited by Thos. L. Stokes, "Carpetbaggers of Industry," reprinted from the *New York World-Telegram*, and other Scripps-Howard papers, pp. 38–39.

an advantage. Overcrowding is sometimes profitable only to real estate owners.

It should be observed also that tax concessions and other inducements are at the expense of taxpayers who do not receive them. In some cases, they may be at the expense of those who compete directly or indirectly with the recipients of favors. In any event, they are at the expense of the general taxpayer—the homeowner, wage earner, merchant, professional man, and, to a lesser extent, the farmer. These people may all stand to gain in the long run by the industrial development which the inducements seek to foster. But they are the ones who meet the immediate cost of the concessions to industry.

Inducements take many forms. Some are legal and some illegal. Some states provide tax exemption for new industries either on a mandatory or an optional basis. In the latter case the decision is usually determined by a referendum. Some also permit a municipality to pay for a new plant out of taxes or public borrowing.

The illegal concessions may take the form of tax administration especially favorable to business concerns. There is some evidence that manufacturing plants in Wisconsin are assessed, on the average, at a substantially lesser proportion of assessed to true value than are homes and farms. Illegal concessions may also take the form of a tax exemption or gift not authorized by law. Concessions may also be private, in which case they are usually provided by some association other than the municipality. If we are to have municipal inducements, it is probably preferable that they be offered by private organizations and that they take the form of assistance to new industries in raising equity capital from local sources. This would be within the law; it would ensure that promoted industries develop local roots; and it would help new industries at a point where they often have a severe handicap.

In conclusion, we have said that if municipalities are to engage in industrial promotion they should at least be discriminating and consider their long-run interests. It seems highly probable that positive promotion of a sound sort is most likely to be undertaken by a private rather than a public organization. The pressure for municipal incentives developed particularly during the depression, when desperate remedies seemed better than their alternatives. If we can solve our general economic problem of maintaining national income at high levels, this sort of pressure need not recur. It is very likely that, in the long run, most municipalities will fare best by giving no inducements at all. Many cities are committed to the policy that special inducements are a losing proposition. Their attitude is expressed in a reply to an inquiry concerning inducements sent out by the National Association of Municipal Officers:

> Up to the present the local government has taken the position that any enterprise without financial backing enough to enable it to move to a good town, might be undesirable and may, if improperly financed, go on the rocks and leave its workers subjects for relief. In plainer words, if you can't pay your railroad fare, stay where you are, and if you do come, be prepared to pay your share of the cost of local government.

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ROBERT MURRAY HAIG

The Coordination of the Federal and State Tax Systems

A LARGE and growing problem of the tax system in the United States is that of intergovernmental fiscal relations. A major phase of this problem is the coordination of federal and state taxes. The remaining selections of this chapter are devoted to this and other aspects of fiscal relations.

As president of the National Tax Association, Robert Murray Haig in 1932 presented for his presidential address to the Association's conference the following analysis of the coordination problem: *

After decades of obscurity in the dark recesses of academic lectures and treatises, the subject of the relation of the tax systems of the states and the nation has emerged with startling suddenness into the spotlight of popular interest. Within the last year numerous publicists and politicians have pronounced the existing situation acute and have advanced proposals looking toward remedial action. The purpose of this paper is to review briefly the status of the problem and to analyze in a critical and constructive fashion some of the suggestions which have been made for changes in the fundamental framework of our American system of public finance.

Attention is directed first to the main characteristics of the existing relationship between the federal and state tax systems and to the causes of the present wave of dissatisfaction. The paper will then discuss the various proposals for reform, with particular reference to the promise they offer of meeting the specific difficulties complained of and to the costs and disadvantages which their adoption would entail.

Experience under the Articles of Confederation taught the American people at least one important financial lesson. It taught them that the dignity of a political entity charged with sovereignty requires a financial foundation more dependable than the right to make requisitions upon its constituent states. The proof of this is to be found in the liberal financial provisions embedded in the Federal Constitution. The states there gave to the Federal Congress the right to impose any kind of tax it might choose at any rate it might choose, and the sole right to levy customs duties on imports, the only restrictions being that the purpose of the taxation must be "to pay the debts and provide for the common defense and general welfare of the

* *1932 Proceedings,* National Tax Association, pp. 220–233.

United States," that direct taxes, then understood to comprehend only taxes on property and polls, must be apportioned among the states according to population, that no export tax may be levied and that all taxes must be "uniform."[1] These powers, amazingly broad as they are when compared with those of the Federal Government under the Confederation, were extended still further by the Sixteenth Amendment which was adopted after the Supreme Court had, in 1895, declared the income tax to be direct in character, the effect of the amendment being to throw that form of taxation outside the rule of apportionment. Moreover it has been conclusively shown that this rule of apportionment prescribed for direct taxes by the constitution found its taproot in ground which today is only of historical interest, namely in the slavery controversy.[2] The intent was not primarily to limit the extent of federal taxation. Thus the states certainly have been generous in granting powers of taxation to the Federal Government in the past and I venture the prediction that the states would readily assent to the complete abolition of the rule of apportionment, if in some future exigency the Federal Government should desire to use the capital levy or the net-fortunes tax.

Within the wide limits of these provisions of the federal constitution there gradually evolved that system of federal taxation which was in force when all but the very young among us first became interested in public finance. For about forty years following the Civil War, with the minor exception of the period of the Spanish unpleasantness, the Federal Treasury depended almost entirely upon customs duties and excises. The states, on the other hand, depended almost entirely on the property tax and on special corporation taxes. The relation between the two systems is commonly described as "separation of sources," a phrase which is accurate enough to serve if one remembers, as some do not, that the word "source" as here used means merely a type of tax and not the ultimate source of the purchasing power. In any event, the relation to which we, as well as our fathers, had become accustomed was one in which the Federal Government used types of taxes which were not also used by the states and in which there was practically no interchange or transfer of funds between the two. This may be referred to as the traditional relation.

Since we, in this country, are not over-rich in traditions and are therefore inclined to worship unduly those that we have, it may be well to recall immediately a few facts regarding the vicissitudes of this particular tradition. Previous to the Civil War there was a period of forty-five years during which the same tradition in a somewhat different form prevailed. During this period the Federal Government imposed practically no excises, subsisting almost entirely on the proceeds of land sales and customs duties. Indeed these sources alone upon one occasion proved to be more than sufficient for federal needs and gave rise to that peculiar episode, the distribution of the federal surplus among the states in 1837. It is nevertheless true that during periods of stress, usually caused by

[1] Article I, sections 8 and 9.

[2] Charles J. Bullock, "The Origin, Purpose and Effect of the Direct Tax Clause of the Federal Constitution," *Political Science Quarterly*, XV (1900), 216, 452; Edwin R. A. Seligman, *The Income Tax* (2d ed.), p. 340 *et seq*.

war, the traditional relation has always encountered rough sledding. Upon no less than five different occasions, the first being in 1798 and the last in 1861, the Federal Government resorted to direct taxes on property, observing, of course, the constitutional rule of apportionment according to population. Moreover, the income tax was extensively used during the Civil War under the impression that it was an indirect tax, and that interesting hybrid, the inheritance tax, was resorted to during the Spanish-American War. Thus on the whole the record justifies the statement that throughout its history the basic strategy of federal finance has been to rely on excises and customs during normal times but to resort freely to other imposts, including direct taxes, in times of stress.

The manner in which the traditional relation between state and federal tax systems has been disturbed during the last two decades is familiar to all and need not be described in detail. The tax systems of both the nation and the states have been radically changed and the resulting relationship between them differs strikingly from that which we all had come to regard as normal. The revolution in federal taxation began in 1909 with the corporate excise tax measured by net income which was merged into a comprehensive personal and corporate net income tax in 1913 after the ratification of the Sixteenth Amendment. The war brought the enormous development of the income tax, as well as the introduction of the excess-profits tax and the capital-stock tax and the reintroduction of the estate tax. In 1924 the interesting credit provision for state death duties was introduced into the federal estate tax. In the tax systems of the states, the outstanding developments have been the spread of income taxes following the Wisconsin demonstration of 1911, the universal adoption of the gasoline tax and the growth of state taxes on such articles as tobacco. When this Association was founded there was practically a complete absence of cases in which the same type of tax was used simultaneously by the federal and the state government. Today the only type of tax on the federal list which is not also widely utilized by the states is the tariff, reserved by the constitution exclusively to the Federal Government. Personal income is twice taxed in twenty states, once by the nation and again by the commonwealth. Corporate income is also twice taxed in twenty states. Gasoline is twice taxed throughout the entire country. Duplication of death duties is universal except in the one state of Nevada. In thirteen states tobacco is twice taxed and in a scattering of states soft drinks, admissions and stock transfers are subjected to tax first by the federal and then by the state government.[3] Dual administration of the same types of tax and a considerable transfer of funds from the Federal Treasury to the states, instead of separation of sources with practically no transfers, has come to be the characteristic feature of the relation of the tax systems of the states and the nation.

This contrast, however, can easily be over-emphasized. It must be remembered that we are dealing here with types of taxes, not with sources of income. Fundamentally the states and the Federal Government continue to fish in the same trout stream.

[3] The statements made above are based on information gathered in February, 1932.

The Federal Government continues to take exclusive toll of the trout entering this stream from foreign waters and to fish the entire length of the stream. Each state continues to exploit its own pool but is forbidden to obstruct the passage of the fish from one pool to another. The change which has come about has been in the character of the fishing tackle. Formerly the states used one type of tackle and the Federal Government a different type. Today both use all kinds of tackle in common, not excluding, some taxpayers plaintively suggest, dynamite itself.

Dissatisfaction with the situation as it now exists is widespread and is becoming increasingly vocal. The President of the United States and the Secretary of the Treasury have both recently called attention to the shortcomings of the present arrangement. Governor Roosevelt also finds fault with it. Among the leaders in this Association, ex-President Graves and Vice-President Edmonds have joined in criticisms and in suggestions for modification. Time permits only a brief summary of the public pronouncements of these leaders who all agree on only one thing, that change is desirable. All are unhappy but are unhappy for different reasons, and what makes one glad, makes another sad. All desire change but desire change in different and even opposite directions, and what is one man's meat is another's poison.

It is obvious that despite the interest of national leaders, the movement for change in the existing arrangement is primarily a movement of and by the states. The Federal Government does not seek additional taxing power. Moreover it possesses a great tactical advantage in that, speaking generally, it can first formulate its tax program, and fold its hands, while the states struggle to conform their programs to it. At most there is some concern at Washington lest the nuisance and waste of the dual administration of certain types of taxation, which constitute important elements in the federal system, may discredit these taxes and render them unavailable. Thus it comes about that the federal comment assumes the form of expressions of concern for the general taxpayer, subject as he is to duplicate taxation on the same base without any arrangement for coordination and control. There is no evidence of alarm for the welfare of the Federal Treasury.

President Hoover in his address before the Conference of Governors in April complained that "The many provisions of multiple taxation vary so much that a taxpayer coming under several jurisdictions may find himself paying a wholly unreasonable amount for the support of government," and urges that "all . . . give renewed examination to this subject in the light of conditions today and . . . consider the possibilities of . . . better coordination, greater simplicity, and, above all, better adjustment of the burdens among the people."

Again, Mr. Mills, the Secretary of the Treasury, in a scathing attack before the New York City Bar Association the same week, elaborated the "maladjustments, duplications and irregularities" of the existing arrangement. Said Mr. Mills: "Our present system of taxation, if it can be called a system, is permeated with inequity, uncertainty and administrative difficulties; the cost of collecting taxes is much too great, as is also the cost to the taxpayer in determin-

ing his tax liability and in furnishing the tax collector with the information required for the same purpose. We have too much tax competition, too much litigation and dispute. . . . We are sorely in need of simplification and uniformity; we need a much greater degree of cooperation and coordination in the framing of fiscal policies." In Mr. Mills' able address, which has been reprinted in full in the *Bulletin,* there is much evidence of sympathy for the taxpayer and understanding of the plight of the states. However, there is no apparent worry for the Federal Treasury and no definite recommendation for reform beyond the establishment of a commission on which the interests of both the federal and state governments would be represented. Such a commission had already been called for by a joint resolution introduced by Representative F. M. Davenport. This failed of passage, but in June it was announced that a group of the members of the Committee on Ways and Means of the House would devote themselves to a study of the problem during the coming months with a view to making recommendations to the next Congress.

The interest of Governor Roosevelt was stirred as the result of his experience with the New York State budget last winter. To balance the budget he recommended increases in the existing state taxes on income, gasoline, motor vehicles and stock transfers, all of which the legislature enacted into law. Strikingly enough at the very same time the Congress, in attempting to balance the federal budget, was considering, and ultimately imposed, additional federal burdens on the same four bases. Thereupon Governor Roosevelt, in a political speech in January, proceeded to point out that "business men have had neither the courage nor the intelligence to suggest that the whole taxing system of America be put on a business basis." The cure he urged was to "follow the original principle established in the Constitution of 1787." "Let us establish for times of peace a definite apportionment of the whole field of taxation," in other words, separation of sources. It may be observed that this is exactly what the Constitution of 1787 does not do. It may also be of interest to those who would seek to solve this problem by a return to "Jeffersonian principles" that Thomas Jefferson's principles did not prevent him, in his inaugural address in 1805, from recommending an elaboration of the "welfare clause" of the Constitution so as clearly to authorize the use of federal funds for internal improvements, arts and education.[4]

By a curious coincidence during the very month when Governor Roosevelt flamed forth in favor of separation, his Director of the Budget, our genial and able ex-President, Mr. Mark Graves, published an article which illustrates very well the sharp clash of opinion and the wide diversity of judgment at present characteristic of the discussion of this topic. Mr. Graves also does not like the existing relation of state and local revenues. He, however, stresses a different reason for dissatisfaction, that is, tax competition among the states. "If we fix our (personal income tax) rates too high," he says, "people would take up residence in states having no personal income tax." When he comes to consider remedies he finds little virtue in the plan of

[4] Davis R. Dewey, *Financial History of the United States* (8th ed.), p. 217.

separation of sources, urged by Governor Roosevelt. He recommends a diametrically opposite course of action—the extension of the crediting device, now used in connection with the death duties, to the new fields of personal and corporate income taxation. " 'Hand in Glove,' not 'Each in his Own Back Yard,' " is the title of his article in the January issue of *State Government*.

Enough has been quoted from recent pronouncements of leaders of public opinion to indicate that there is indeed a fluttering in the dovecotes; that the injuries suffered by the taxpayers and by the states under the present arrangement are considered to be serious, but for varied reasons; and there is wide difference of opinion as to what should be done to improve matters. Let us now turn to an analysis of the underlying causes of the present discontent.

As I see the situation, those causes are complicated. Some of them relate to the difficulty of accommodating the interests of the states and the Federal Government, others relate to the difficulty of accommodating the interests of the states to each other. The accomplishment of the necessary accommodations probably requires action from the Federal Government.

To revert to the fishing metaphor once more, the first difficulty is the almost inevitable irritation which arises when two people try to fish the same pool. Each state has its own pool, it is true, but the Federal Government, unless it can live on the customs duties alone, as it largely did prior to the Civil War, must fish in every state's pool. It is not surprising that the lines become entangled, the peace is disturbed, and the two fishermen together land perhaps fewer fish than one fishing alone. It is necessary somehow to articulate the interests of the states and the Federal Government.

In the next place the plain fact is that, with the progress of economic and fiscal technique, the existence of state lines constitutes an increasingly serious obstacle to efficient state tax administration. Here we have not one but a cluster of problems. The first of these state-line problems may be illustrated in this fashion. Each state may fish in its own pool and, even though the fish be fast and slippery, no state can impose burdensome restrictions upon their passage into another pool. The "commerce" clause of the federal constitution, which will be more fully discussed by others on this program, has developed into a very troublesome game law indeed. The puzzled reader of the court decisions is inclined to conclude that the apparent intention of the framers of the constitution that the states shall not construct weirs at the exits of their pools has somehow been transformed into a rule that the state may legally take only those fish which chance to have their noses pointed toward the center of the pool when the fly is cast. So exhausting is the effort to reach taxpayers engaged in interstate commerce, even though the object be to impose upon them merely the same tax burden as that laid upon those engaged in intrastate trade, that many state administrators deem it desirable to resign the fishing-rod to the federal authorities for whom interstate complications do not exist and who are free to cast a fly without determining first which way the fish's nose is pointed. There may be other ways to solve this interstate commerce difficulty but until one is

found the movement toward delegating more tax functions to the Federal Government will continue to receive hearty support from a large group of state tax officials.

The second difficulty in adminstering state taxes caused by the existence of state lines is that of localizing the tax base. The fish in this stream often spawn in one pool and feed in another. Shall a state be permitted to raid the spawning beds? This difficulty is in part legal and in part economic in character. From the economic point of view, for example, it is often exceedingly difficult and sometimes quite impossible to determine the particular areas in which the profits of a far-flung business enterprise arise. Even with property, except, of course, real estate itself, correct localization presents puzzling problems. In spite of the best efforts of state tax administrators, evasion on the one hand and double taxation on the other often results. On the legal side, the trouble lies not merely in the "commerce" clause but also in the rich opportunity offered by the "due process" clause of the Fourteenth Amendment to the taxpayer to upset an essentially fair allocation on the ground that it is "arbitrary." With their tackle tangled in the snags of "due process" objections, many state administrators see in federal administration a complete solvent of all problems of localizing the tax base.

The third difficulty traceable to the existence of state lines has been alluded to above as tax competition among the states. The trout in this stream, particularly the big ones, are exceedingly wise and wary. They have been known to select their pool on the basis of the character of the tackle legally available to the fishermen. Some states have even been suspected of advising the trout that they would not be exposed to the hazards of particularly deadly implements, such as the inheritance tax, if they would consent to inhabit their particular pools. That this factor weighs heavily in the deliberations of state bodies charged with responsibility for fixing the rates of income, corporation and estate taxes there is abundant evidence. Federal taxes instead of state taxes would, of course, standardize fishing practice for the whole length of the stream. This factor of interstate tax competition, which, it was felt, stimulated an unwarranted industrial migration, was in large measure responsible for the radical nationalization of taxation which has taken place in Germany in recent years.

Finally, some of the pools in this stream are so small and so poorly stocked with fish that the results of the fishing do not justify the use of expensive modern tackle. For example, certain states simply cannot afford the investment in the split bamboo of the personal income tax. They must be content to fish with a crooked stick and a bent pin. There is a conviction that duplication of equipment in the hands of the states and the federal authorities is largely waste anyway and this strengthens the disposition to allow the fully accoutred federal fisherman to have a free hand to deal with the few fish in these poor pools.

So much for the shortcomings of the present relation between the federal and state tax systems as viewed by the states. From the standpoint of the taxpayer and the citizen there exists a *prima facie* case against dual administration of the same taxes on the ground that it is wasteful, involv-

ing unnecessary expense both in expenditures for tax-gatherers and in the time and energy of taxpayers. There is also an essentially sound general conviction that all functions of government, including that of the levy and collection of taxes, should be assigned to the various jurisdictions for administration on the basis of their power efficiently to perform them.

How serious are the wastes of dual administration is not precisely known but they are certainly substantial. Dual administration can be avoided in three different ways. All the taxes may be assigned to the states, who will then share the yield with the Federal Government, approximately the discredited method of the old Confederation. Second, all the taxes may be assigned to the Federal Government, which will then proceed to subsidize the states. This is so radical a proposal that no one has dared to advance it. The third way to abolish dual administration is to assign certain taxes to be administered exclusively by the Federal Government and others to the states. Clearly it is in this direction that a solution must be sought if the decision is reached that the wastes of dual administration are sufficiently substantial to outweigh the probable costs and disadvantages involved in the change. This does not necessarily imply separation of sources with each jurisdiction subsisting exclusively from the proceeds of the taxes it administers. The requirements are also met by what may be called integration—the exclusive federal administration of certain taxes whose yield is shared with the states.

From the numberless possible plans of adjustment which might be suggested, only three will be here discussed. Separation of sources, crediting, and integration will be taken up in order.

First, then, what are the virtues and vices of the plan of separation of sources whose most prominent advocate is Governor Roosevelt? As has been pointed out above, it avoids the wastes of dual administration and it appears to give liberty of action to the states in planning their budgets. This liberty, however, proves upon examination to be more apparent than real. Suppose, for example, the particular plan of separation adopted assigned the property tax to the states and the personal income tax to the Federal Government. Could each then proceed to exploit its tax without reference to the action of the other? Within limits, certainly; but it is also obvious that the federal income tax could be made so heavy as seriously to impair if not entirely to destroy the property tax and *vice versa.* Indeed under no imaginable plan of separation, with aggregate tax burdens what they are today, would the states have real liberty to proceed without regard to the action of the Federal Government.

A more serious shortcoming of the plan of separation of sources is the violence it would certainly do to the principle of efficiency in the distribution of governmental functions. If the taxes were assigned to those jurisdictions which can best administer them with no provision for transfers of part of the yield, and if the functions of government in general were distributed by the same test of efficiency, it is almost inconceivable that the resulting patterns of costs and revenues would be even approximately identical. If, by some freak of fortune, they should chance to be so at a given moment, changes either in

governmental functions or the conditions which govern efficiency in administration would immediately destroy the identity. As a practical matter, either efficiency in the administration of taxes or efficiency in the performance of other governmental functions would have to be sacrificed on the altar of the balanced budget. This difficulty is not an imaginary one. The experience with the device of separation of sources in such states as California brilliantly illuminates the point. The task of making a federal-state plan of separation flexible and adaptable to constantly changing conditions is substantially more difficult than the corresponding task in the state and local sphere.

Whether or not separation of sources offers a way out of the four "state-line" difficulties discussed above depends, of course, on the particular types of taxes assigned to the Federal Government for administration and use. A reversion to the traditional relation would solve none of these difficulties, neither the interstate commerce difficulty, nor the base localization difficulty, nor the interstate tax competition difficulty nor the problem of the uneconomic administrative district. On the other hand, to assign to the Federal Government all the taxes necessary to solve this group of problems would flood the Federal Treasury to overflowing and impoverish the states. The inevitable conclusion is that the plan of separation of sources is entirely inadequate to the task and is not an attractive way out. What, then, of the second proposal, the extension of the crediting device?

The eight-year experience with the crediting device of the federal estate tax seems to justify the claims of those who felt that its adoption would mitigate to some extent the evils of interstate tax competition and exert an influence in the direction of uniformity and equity in death duties. Certainly the conditions today when compared with those of the hectic days of our inheritance tax conferences a decade ago offer comfort to those optimists who believe that progress is possible even in the field of taxation. But the federal credit does not deserve all the praise for the improvement. Voluntary reciprocity among the states and a radical series of court decisions are also claimants for the honors.

Almost without doubt the extension of the crediting device may be expected to reduce tax competition, lessen evasion and encourage uniformity. Moreover, its legal foundation is apparently settled.[5] Its introduction would involve less disturbance and friction than either separation or integration, a point of powerful appeal to the politically minded, although, when one recalls the resentment of the insignificant number of states without death duties at the time of the introduction of the federal estate tax credit, he must realize that all would not be plain sailing for a federal credit for state income taxes when only twenty states have such taxes or for state tobacco taxes when only thirteen states now choose to impose them.

The technical problems involved in an extension of the crediting device to such fields as that of the federal corporate income tax have thus far received practically no consideration or discussion. Before such a credit can be seriously urged, satisfactory answers must be found to

[5] Florida *v.* Mellon, 273 U.S. 12, 47 Sup. Ct. 265.

many difficult questions. Assume that the rate of the federal tax has been agreed upon and also the extent to which the state taxes shall be considered valid for crediting purposes. What types of state corporation taxes shall be recognized as offsets against the federal tax? Must they be *net* income taxes? Shall a tax which stresses corporate excess as well as net income, like the Massachusetts tax, or a tax which provides for a flat minimum and a low capital stock tax alternative, like that in New York, be deemed acceptable? What would be the status of a state net income tax with an alternative tax on gross such as has been suggested in New York? What would be done with a state corporation tax purely on gross, and will any distinction be made between a tax on gross which is in lieu of property taxes on the corporation and one which is in addition thereto? Shall property taxes imposed on corporations be accepted for the credit, and if so, how shall property be defined? Shall it include real estate and, if not, how shall real estate be defined? Shall corporate excise taxes which include in their base certain interest or other items which the Federal Government is without power to tax be accepted in partial settlement of the federal levy? How shall the problem of variation in practice regarding basic dates for valuation of assets be met? Shall there be a limitation upon the amount eligible for credit from each state and, if so, on what basis shall this allocation be made? What shall be done about the various special types of public utility taxes? How shall the state taxes on banks be treated? Of what significance would the credit be for state insurance taxes, which are almost exclusively on gross, in view of the virtual collapse of the federal net income tax on such companies?

Almost no questions such as these arose in the case of the estate tax credit and not all arise in connection with a proposal to credit state personal income taxes and consumption excises. But enough has been said to indicate that the proposed extension of the crediting device needs to be elaborated in detail before its practicability can be intelligently judged.

Even if all the technical questions can be answered, however, the crediting device offers at best only the possibility of a partial solution. The wastes of dual administration are not eliminated or even reduced. Neither does it provide a cure for the problem of interstate commerce, the problem of localizing the tax base or the problem of uneconomical administrative districting.

The indicated conclusion is that, while the extension of the crediting device may have its temporary and tactical uses, its apparent simplicity conceals many technical difficulties and that its potentialities for the alleviation of existing ills are extremely limited.

There remains the third type of modification; the assignment to the Federal Government of all those types of taxes in the administration of which it possesses a substantial advantage as compared with the states, with provision for such a division of the yield with the states as is appropriate to the functions assigned to them on the basis of the principle of efficiency. The practical application of this plan would result, I feel sure, in the federal administration of the bulk of the taxes on sales and consumption and, I suspect, in the federal administration of the death duties and the personal and

corporate income taxes as well. Such a program has the theoretical potentialities of a complete solution of all the difficulties which prompt the present criticism of the existing relation. It calls for an efficient distribution of governmental functions including that of tax administration and eliminates the wastes of dual administration of the same taxes. It appears to eliminate all four of the obstacles to efficient state tax administration traceable to the existence of state lines—by the device of eliminating the lines whenever they are obstacles.

The disadvantages of this proposal, however, should not be minimized. It is surgical treatment. To some it seems like cutting off the foot to cure a corn. To others it is merely the quick and merciful job of the surgeon's knife lancing an infection which threatens to develop into general poisoning of the system. Perhaps the most serious question is this: Is it reasonable to hope that a sound and satisfactory arrangement can be worked out for distributing among the states the funds collected for them by the Federal Government? If the answer is negative, this plan must be discarded. Before asking support to a proposal for integration, therefore, the proponents should elaborate their plans for distribution, for here is the heart of the problem. Shall the distribution be based on the theory that the Federal Government is acting as the agent of the states in administering state taxes? If so, the question for which an answer must be found is: Whose taxes are these? An excise on cigarettes designed as a consumption tax but collected from the factory in North Carolina would go, not to North Carolina, but would be distributed among the states according to estimates of consumption. The proceeds of a business income tax would be distributed in accordance with the answer given to the question: Where did this income arise? In other words, the whole allocation problem, far from being solved, is merely transferred to the lap of the Federal Government for solution. If the distribution is to be based on the theory that the taxes are true national taxes the indicated plan of distribution would be quite different. The money should then be thrown in support of functions of general national concern and apportioned among the states for designated purposes, such as for roads or schools, in accordance with standards of need and economic strength.

I could be more enthusiastic for integration if some of my oldest and wisest friends were not so certain that no satisfactory solution of this distribution problem is possible. I have personally witnessed enough of the hard-boiled political grabbing of central funds to transform a saint into a cynic. Nevertheless the picture is not wholly a dark one and enough progress has been made, particularly in the technique of distributing money in support of public education, to justify the hope that the problem is not insoluble.

In conclusion, it can be asserted with confidence that, while none of the proposals for coordinating the federal and state tax systems offers a clear and unobstructed road out of the present morass, the expansion of federal administration offers on the whole fewer difficulties and greater rewards than either separation or the crediting device. Gradual progress in the direction of the nationalization of the tax system seems to be almost

inevitable. It is in harmony with the experiences of state finance in this country. If the history of Germany, where the governmental structure rather strikingly resembles our own, is of significance for us, this line of development is to be anticipated. The very stars in their courses seem to fight for it. Each technical advance in the field of transportation and communication makes it more certain. The cost, in time and labor, of overcoming the friction of space is, after all, the most important factor governing the economical size of the administrative unit. Today in these terms the United States of America is much smaller than was the state of New York alone when the Constitution of the United States was adopted this week one hundred and forty-five years ago. I suspect that no amount of high-sounding talk about states' rights and the principles of our federal form of government will ultimately prevail against the indignation of a citizenship compelled to go through useless and expensive motions to conform to duplicate tax laws and to meet the costs of duplicate tax machinery, especially if there is added the confession of state tax officials that they are so hamstrung and circumscribed by state lines that they cannot successfully perform their tasks.

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HAROLD M. GROVES

Intergovernmental Fiscal Relations

THE following selection * by the editor is a summary of the major conclusions from a study of intergovernmental fiscal relations made by a committee on this subject for the United States Treasury.

The following observations on intergovernmental fiscal relations are based on and are mainly taken from a report recently prepared on this subject by a committee consisting of Luther Gulick, Mabel Newcomer and myself. The committee was assisted by a small staff. The project was sponsored by the Treasury Department and the report has now been completed and submitted to the Treasury Department. The views here expressed are those of the committee; they have not been endorsed by the Treasury.

1. *History*

The history of the fiscal coordination movement, if so it may be called,

* *1942 Proceedings,* National Tax Association, pp. 105–119.

is a familiar story to the members of the National Tax Association. Only a few highlights can here be recalled. It will be remembered that during the Twenties, principal interest in coordination centered about the effort of state tax officials and others to induce the federal government to withdraw from the estate tax field. Acting at the suggestion of President Coolidge, the National Tax Association organized a conference of federal and state tax officials; after a close vote and much argument, the conference adopted a committee proposal for the repeal of the federal estate tax in six years, reduction in rates, and increases in the credit provision (established in 1924) to 80 percent. Congress, in 1926, reduced estate tax rates and increased the credit to 80 percent, but did not provide for repeal.

During the depression and defense-preparation periods, from 1931 to 1941, interest in fiscal coordination increased rapidly. Federal interest and activity took many forms, among which was a study of "Double Taxation" by a Congressional Joint Committee on Internal Revenue in 1932. The President repeatedly expressed his belief that "no really satisfactory tax reform can be achieved without readjusting the Federal-State-local fiscal relationship." This view was shared by the Secretary of the Treasury.

The period was characterized by much activity of the interstate organization (with headquarters in Chicago), whose Interstate Committee on Conflicting Taxation did the most exhaustive research on federal-state fiscal relations and submitted comprehensive and able reports on the subject. However, an intergovernmental council, which grew out of this movement, made no substantial progress.

The National Tax Association has always taken a lively interest in the coordination problem. The 1933 conference of the Association appointed a committee on the subject but great difference of opinion developed and no final committee report could be agreed upon. Nothing daunted, the Association in its 1940 conference authorized a new coordination committee. As you know, the new committee has been organized and is at work on the problem; it has established close working relationships with a similar committee from the American Bar Association. Out of the earlier efforts of the Association, and sponsored by some of the members of the 1933 committee, the Graves-Edmonds Plan developed. It suggested federal administration of certain major taxes subject to dual administration and distribution of part of the receipts on an "equitable basis" to the states.

The outstanding report of the Canadian Royal Commission on Dominion-Provincial Relations appeared in 1940.

On the functional side of the coordination problem, the federal government undertook a large new array of functions to cope with the depression; and the Supreme Court accepted the view that the Constitution should be more flexible.

The history of the fiscal coordination movement is characterized by much frustration, wishful thinking, and rationalization, but the efforts expended have brought to public attention a set of problems that are real and urgent. The movement has been led mainly by state officials with less active participation by scholars and business men. It has not been

supported by a groundswell of popular interest, and the lack of participation by farm and labor groups has been conspicuous. There has been no crystallization of opinion concerning the problems involved, even among the experts. The movement has often failed to come to grips with fundamentals; a customary procedure has been to endorse the word "coordination," hand it to a committee which also endorses it, delivers a few generalizations, and recommends "further study." (The author hastens to concede that the report concerning this subject which he, with others, has been preparing has some of the limitations here criticized.) There has also been a conviction that a group of specialists could draft a formula or set of specifications to satisfy all parties when, as a matter of fact, many of the issues involved are beyond the province of the expert. If the time arrives when Congress feels it necessary to take over the main strategic revenue sources of the states and put these governments on an allowance, no extensive study will be required to tell it how or why.

2. *General Observations*

Much valuable energy has been wasted unnecessarily in quarreling over the proper sphere of the federal government and the states when prospects of solid achievement lie in the scantily-tilled field of intergovernmental cooperation and coordination.

A change in attitude of revolutionary proportions seems to be needed. The American governmental system has never been viewed as a unit by most public officials, with loyalties evoked and encouraged for the entire system. If the mayor of an important municipality feels that a change in the federal income tax would embarrass his own government, he is likely to feel no great concern as to whether the change is needed to strengthen and equalize the federal system of personal taxation. Federal administrators show equally unfortunate blind-spots. Very often, in addition, they lose a proper sense of proportion, and conclude that all wisdom and authority are concentrated in Washington. State officials who object to this frequently show the same attitude in dealing with municipalities. But much of it could be eliminated by more conscious effort.

Hopes for a solution of the fiscal coordination problem, or for a comprehensive plan for immediate adoption, are probably doomed to disappointment. Some scholars have rejected the idea of "nibbling" at the problem, bit by bit, as entirely inadequate, but it is this not very spectacular method that promises most in the way of progress in what must be a cooperative venture. Indeed the preoccupation of the critics with grandiose plans for fiscal coordination may account in part for the rather low score of achievement to date.

The united and uniform fiscal system of which some administrators dream, is possible only in a unitary state. The best that can be achieved in a federal state is a working compromise, even as the federal state itself is, in its origin, a compromise.

Recent decisions of the federal governments of Canada and Australia to federalize a large part of state tax systems for the period of the war, place proponents of our overlapping tax system on the defensive. Conditions in the two British federal systems differ somewhat from our own. These countries have a highly de-

veloped tradition of allowances (fixed grants) from the central governments to the divisions. State tax rates, particularly in the income tax fields, were substantially higher at least for some of the foreign states than in our own. The tradition of local and state autonomy was less highly developed probably in the British federations. Certain coordination devices, notably in income tax deductibility, were more highly developed in this country than in the British federations, but others such as joint administration were much less developed. Of course, even if there were no differences in conditions, it could not be concluded from these examples that the states should be excluded, in effect, from important tax fields, even during the war emergency. Fiscal independence is a large sector of general independence and the latter a large part of local self-government which in turn has important democratic values for which we are fighting. It has been suggested that another major war might put an end to federal systems, everywhere. Whether or not this is true, it appears to the authors that a large degree of state and local fiscal independence does carry values of a very high order, and that they should not be sacrificed until the necessity is clearly demonstrated. It is not believed that such is yet the case. That state rights should yield to military necessity will be generally conceded. That the war effort would be served by federalization of state revenue systems is, however, very doubtful. The federal government has enough on its hands, for the present, without assuming the responsibility for state finances unless this course would yield very important advantages in ordering its own financial program. That there would be some advantages may be conceded but these advantages (up to the present and in the near future) seem outweighed by the disadvantages.

Proponents of local fiscal independence might well heed the trend of the times, however. Progress in intergovernmental fiscal relations can be made without federalization and may be a means of avoiding the latter.

The centralization of all the major taxes in the hands of the federal government would provide a simple, logical, orderly, and well-coordinated tax system. The centralization of the major service functions would avoid the confusion of transfers and would enable the application of receipts where they are most needed. Together these steps would enable us to dispense largely with some 170,000 units of government. They would give the federal government quite ample fiscal powers to deal with our unstable private economy. But there is no assurance that the resulting unwieldly product would not have worse internal incoordinations and inefficiencies than the external ones so apparent in our present make-shift arrangements. And the loss in intangible values might be even more serious. A federal system is the only one which can give self-government to a continent or to tens of millions of widely scattered free peoples.

But we think that there is another and sounder middle ground, which accepts the framework of the American governmental system and seeks no large shift in the division of power. This view starts with the observation that federal-state relations of all sorts have been marked with coolness, distance, suspicion, and jealousy. Governmental problems in

our modern era have become so large and vital, and participation in a united attack upon them is so essential, that a new attitude, facilitated by new institutions, should be the minimum acceptable program of fiscal modification. While much weight needs to be given to the values associated with autonomous local government, these have to be balanced against the advantages, such as reduced confusion and wider perspective, which attend central control. A priori generalizations concerning centralization are of little use. Each specific problem has to be considered on its own merits. In some cases federalization of a function may (by a balance of the interests), be warranted; in others, retention of the function by states and municipalities may be called for; and most often, probably, joint participation, in one way or another may be the best solution. Decentralization within the sphere of federal activities may also have a place in the picture. The presumption should probably favor decentralized control, but it is by no means a final or conclusive presumption.

Consideration of fiscal coordination may proceed by the examination of the different overlapping taxes and how they may be better ordered; or it may take up the coordination devices and seek to determine the proper place of each in a desirable coordination program. The latter of these alternatives is here chosen as the more promising for covering a large territory in a short time.

3. *Joint Administration*

Among the coordination devices, joint administration is entitled to much attention. It is likely to prove most effective as the approach to coordination of federal and state income taxes, business taxes and perhaps death taxes. To this list might be added retail sales taxes if the federal government enters that field.

More collaboration between federal and state administrative officials offers promise of first-rate achievement in economy and efficiency. Some achievements along this line have already been realized. It is now possible for state officials to utilize federal income-tax returns for information and such services are available on tolerably economical terms for the states. The evidence indicates that some states have utilized this means of improving state administration quite extensively, and other states would be well advised to utilize this cooperative privilege on a wider scale. Particularly the "automatic transcript service," under which states can in effect get the results of federal audit and delinquency action, has proved of high value at nominal cost to those states now using it—more than three-quarters of the income-tax states. Kentucky, for instance, gets something like the equivalent of 20 auditors' work at a cost representing the salary of one investigator for less than one month. The techniques of collaboration have been more highly developed in the liquor-tax field, perhaps, than anywhere else in the tax system. Joint use of facilities, information, and personnel in this field, while quite informal, have been extensive and highly successful. Collaboration in the exchange of personnel and research facilities is not unprecedented in non-tax fields, but it encounters institutional difficulties in taxation. Some preliminary attempts to utilize a single return for state and federal income-tax reporting proved unsuc-

cessful, but the experience in the matter is by no means conclusive.

Experience of the federal government with the automobile use tax is particularly illuminating in the matter of administrative collaboration. In this case there was a strong presumption in favor of federal use of state administration. But the Bureau of Internal Revenue concluded that such arrangement was impractical. Grounds for the decision were that legal authority for a bargaining arrangement was lacking; that the attitude of states toward undertaking the task for the Government was uncertain; that sufficient power or influence to insure the adequacy of state enforcement and accounting was not available; that diversity of state procedure, and the delegation by the states of administration in some cases to the counties made the procedure too complicated. In spite of the absence of formal arrangements some states have rendered considerable assistance in the administration of the federal tax and some have volunteered legislation which requires payment of the federal tax as a condition for the issuance of a state license. The Virginia legislature had before it a bill to make it a misdemeanor to operate a car on the state highways without a federal "sticker." Nevertheless, the experience with this tax proves that delegated administration cannot be improvised but requires very careful and detailed preparation. Joint administration, in the fullest sense of the term, would require even more facilitation.

4. *Federal-State Fiscal Authority*

A large gap in our machinery of government could be filled by the development of a Federal-State Fiscal Authority. A principal function of the authority would be that of promoting closer collaboration between federal and state officials.

Much could be said for an authority which would administer overlapping taxes directly. The experience of Australia, which has made greatest progress in the administrative approach to the coordination problem, points toward a joint administrative agency. But Australia's problem is simpler than that of the United States. The Commonwealth has only 6 states and their revenue systems are more important relatively than those of our 48 states. (The latter factor creates a more even balance of power than prevails in the United States.) One might hope that eventually a federal-state authority of the type recommended here would be given power to administer some taxes in its own right. But at the outset its role had best be confined to that of mediation between federal and state officials. It should be observed, however, that joint administration is not federal administration; a large factor of mutuality is implied.

A Federal-State Fiscal Authority could perform numerous other useful functions. Along with the Council of State Governments and the National Tax Association it could promote interstate cooperation. These organizations, among others, have perceived for some time that a much greater degree of interstate cooperation is required to maintain our federal system in a healthy condition. Some of the gravest problems in the field of intergovernmental relations might be solved if there were a sufficient degree of interstate cooperation. Of all the remedies for these many problems, interstate cooperation ranks first in its promotion of the prestige and independence of the

states. But interstate cooperation, to function efficiently, needs a "friend at court" within the federal government. And it needs an easy vehicle of transition from the field of interstate to that of federal-state cooperation. A federal-state agency should supply the factors needed to lift interstate cooperation to a much more active and more useful plane.

The authority could act as a clearing house and board of appeals in the growing field of federal payments in lieu of taxes on federally-owned property where practices have developed opportunistically and with great state and local dissatisfaction. It could perform or stimulate some very useful research particularly concerning costs of tax compliance and the extent and effects of multiple taxation. It could promote better governmental accounting, research and statistics.

Time does not afford an opportunity even to sketch the details of how such a body should be organized. Suffice it to say that it should be a mutual institution both as to membership and support and that it should include a small full-time membership advised by a more representative council.

5. *Separation of Sources*

Separation of sources as a device for tax coordination was employed in the United States for many years, but the recent tendency has been toward more and more overlapping.

The achievement of separation of sources may be either by constitutional restriction or forbearance. In view of the trends, the prospects of coordination by this means are none too encouraging.

Nevertheless, a strong case can and should be made for separation of sources in the motor vehicle tax field. Here we have the rare case where the federal government has little or no advantage as to administration. The total direct cost of state administration of the motor fuel tax in 1940 was probably not over 3 to 4 million dollars. Cost of compliance by the taxpayer is not large. Diversities in rates and other practices are related substantially to and justified by differences in local conditions, such as the relative status of highway development and the relative adequacy of the tax base.

The federal government should withdraw from the motor vehicle tax field as much and as soon as its financial exigencies will permit. The basis of this recommendation is that this tax field forms a lucrative and badly needed source of revenue for the states, and one which they are exploiting or might exploit quite adequately and satisfactorily.

Looking to the future, it is suggested that federal and state separation of sources in the motor fuel tax field might take the form of exclusive federal taxation of fuel used in aviation and exclusive state taxation of other motor fuel. Two-thirds of the states now exempt aviation fuel from state taxation, and the remainder either have special aviation tax provisions or do not receive much revenue from this source. Potentially, however, the field is promising. It is appropriate for the federal government, since aviation is essentially an interstate enterprise and the licensing of airplanes and the regulation of air travel are already national.

6. *Deductibility*

A coordination device seldom recognized as such is the deductibility of taxes levied by other jurisdictions

in calculating the net base of the tax in the taxing jurisdiction. In the United States this is most highly developed in the field of federal and state income taxes where it (federal allowance for the deductibility of state taxes and in some cases the reverse) materially reduces the total load of the two taxes, diminishes the differentials between income tax burdens in an income tax state and a non-income tax state and avoids threats of confiscatory burdens. It operates to check tax avoidance by migration although this effect has generally escaped attention. Deductibility operates much like a credit although it is less drastic as to degree. For example, if each government allows the deduction of taxes paid the other, the combined load of an 80 percent federal and a 15 percent state rate is only 80.7 percent at the margin (77.3 percent federal and 3.4 percent state).

Deductibility works quite badly for irregular income and in years when tax rates are changed. To mitigate the difficulties arising from these changes, it is recommended that the taxpayer be allowed to report taxes on an accrual basis even though other expenses are on a cash basis. This would mean that the taxpayer could report to the federal government his state income tax payable rather than the cash outlay for income tax purposes during the previous year. It is also recommended that, as soon as revenue needs will permit, states not now allowing reciprocal deductibility provide for it.

7. *Credits*

The crediting device is already in use to provide some coordination in the case of death taxes and payroll taxes. The credit is limited in its objectives; it is an effective antidote for interstate competition but, as used thus far, it has provided little alleviation for the evils of dual administration and compliance, diversities of laws and practices, and multiple taxation. However, the last word has not been written on the techniques of applying the credit.

The credit is the accepted device for coordination in the death tax field but the present application is badly in need of modernization. Inaugurated in the middle twenties, this device consists of an allowance up to 80 percent of the federal tax as computed under the 1926 federal estate tax. The federal law has since been amended several times, and the rates revised upward and the exemptions downward, but the credit is still tied to the now antiquated 1926 law. The credit does not apply to the federal gift tax, inaugurated in 1932; a similar tax is now included in the inheritance tax systems of 11 states. At the very least the credit should be adapted to the most recent estate-tax statute, with applicability in terms of present rates, and exemptions, and to the taxation of gifts. Better still, the entire estate-tax system should be overhauled; federal exemptions should be reduced to at least the average level of state exemptions; the estate and gift taxes should be integrated, and the crediting program should be brought into accord with current federal practices. Going further, the credit should be broadened in an effort to eliminate dual administration and multiple taxation. States are now required to build up the taxpayer's liability to the state before the federal credit is applicable. But the federal government could and should assume this task of determining the taxpayer's

liability to the states. Or better still, the matter could be handled by joint administration. The right to determine jurisdiction might well be imposed as a condition under which the federal government would offer its administrative services to the states.

8. *Sharing*

The system of central collection and local sharing is very attractive to those who have a passion for logical and simple mechanisms, but it encounters very impressive objections. It involves a very high degree of centralization and usually serious problems of division and adjustment to local needs. Considerable experience with federal sharing in Germany is said to have led to state and local extravagance in the few years of prosperity in which it was applied, and in times of depression it brought maldistribution of funds, since the neediest districts usually received the least. Constant revision was found necessary in order to keep the system going at all.

An overlapping tax situation most favorable for sharing would present the following characteristics:

1. State imposition of the tax is fairly general and fairly uniform. Otherwise, the charge will be made that the federal government is forcing the spread of a particular kind of tax. Some degree of uniformity is necessary in order to strike a least common denominator of distribution which will satisfy most of the states and at the same time not be wasteful of federal money.

2. State administration is expensive or otherwise unsatisfactory. This provides the cause for action in inaugurating sharing.

3. Simple and acceptable bases of distribution are readily available. This will help to avoid excessive "politics."

4. States have a relatively small stake in their discretion over rates and other provisions connected with the particular tax. This is important to minimize the loss of state sovereignty which sharing involves.

If any federal-state tax situation presents all these characteristics, it might be worth recommending for an application of the sharing device at least as an experiment. The tobacco tax is the principal candidate and it measures up to the above qualifications quite well.

State administration of the tobacco tax has important limitations. Such administration is necessarily quite decentralized and considerably more expensive than federal administration. Very often the states give discounts ranging up to 10 percent or more to the tobacco merchants as an allowance for expense of affixing stamps. Even more important is the very substantial avoidance of state tobacco taxation by interstate purchase. When all the leaks and costs are considered, it is quite possible that state tobacco taxes are only from 70 to 80 percent efficient.

It is recommended that the federal tax on cigarettes be increased to the extent of two cents per standard package and that the share of federal revenues represented by this portion of the tax be distributed to the states on a per capita basis. Account of differences in consumption could be taken by weighting the population in favor of the urban portion. The distribution would be conditional upon state and municipal withdrawal from the field. Similar arrangements should be made with regard to other tobacco products. A minimum but

gradually vanishing guarantee should be included to safeguard state and local revenues.

It may be contended that the liquor tax is eligible for the same recommendation as that made for the tobacco tax. But the case of the former is quite different from that of the latter. Diversities are greater and are associated with regulation which in turn is adjusted to a wide range of difference in local opinion. National regulation of the liquor traffic has been tried and found wanting. Forbearance is the coordination device which seems most appropriate for the liquor tax field.

9. *Supplements*

It is often proposed that the federal government impose and administer certain taxes, at the same time inviting the states to add a percentage to the federal levy. Precedent for such procedure exists in France and Mexico, and to a limited extent in the United States. In its extreme form this has never been popular in this country. But state supplementation of federal programs consists mainly of two elements, single administration and uniformity of laws. Viewed in this light, supplementation can be approached by degrees and is a highly desirable objective in such fields as those of income and death taxation.

10. *Grants in Aid*

The subvention device is well adapted to use in a federal system and our own use of this instrument might well be extended as well as improved. The aid system permits the distribution of receipts from the federal income and death taxes (often not subject to fair localization) and relieves the pressure in the state and local quest for revenue.

Evidence concerning the geographic distribution of income discloses wide differences; in fact the average income in one state is not even an acceptable relief standard in another. The average old age pension in one state exceeds the per capita income in the poorest state by 70 percent.

While the scope of federal aid developed very rapidly during the depression years of the Thirties, it is a mistake to call the existing practices a system. In many states, certain federally supported functions, such as old age assistance and vocational education, have tended to get the lion's share of federal, state, and local support at the expense of such locally supported functions as relief and general education. The system should be revised and brought into balance by an extension of its scope to include additional functions in which there is a clear national interest. The strongest claimants for the extension are elementary education and general relief.

The control features of an aid program can be a very salutary influence and ought to receive more rather than less emphasis in the future. In addition to the traditional control devices, such as audit and inspection, and approval of state plans, educational aids should give attention to internal equalization, redistricting, and division of funds between whites and negroes. All the aids should seek to improve standards of local government personnel. It is probable that more can be done in most cases with persuasion than coercion. Some outside criticism has a salutary effect on almost any government, and it is unfortunate that

the federal government is not in a position to get the benefit of similar criticism from the states and municipalities.

The development of differential or equalization aids has strong ground for support, particularly as applied to elementary education where the case for a minimum program is especially strong. In the case of welfare aids the application of differentials is more doubtful since welfare standards are properly adjusted to prevailing levels of wealth and income in the states. A desirable system for the welfare field would be a graduated bracket system of distribution under which the federal government would contribute a larger proportion of the assistance granted clients up to a certain standard and a lesser proportion thereafter. This would avoid difficulties of differential distribution formulae, assert the national interest in bare minimum standards and encourage intra-state equalization.

11. *Governmental Instrumentalities*

A storm-center in intergovernmental relations is the treatment of governmental instrumentalities in federal and state taxation.

One aspect of this field is federal payments in lieu of local property taxes on the large and growing volume of federally-owned property. As previously suggested, federal practice with regard to this matter has developed opportunistically and has occasioned much state and local dissatisfaction. Without attempting here to analyze the myriad specific problems in this field it can be recommended that there be developed some machinery whereby consistent rules can be established, revised, and used effectively. What is needed is a clearing house for payments-in-lieu proposals. An agency of the sort suggested could also play a useful role in hearing complaints concerning payments in lieu of taxes. A Federal-State Fiscal Authority could function effectively in these two roles.

A better correlation of programs for payments in lieu of taxes might also be promoted were Congress to establish a special joint committee (perhaps temporary) to consider the large volume of new legislative proposals which fall in this field.

It is recommended, further, that the federal government provide the facilities for a continuing inventory of public property. This is desirable not only for its own sake but also to facilitate the development of balance-sheet accounting for the government.

Another issue in the instrumentalities field is that of state sales taxes on purchases of government contractors. The United States Supreme Court recently held that in the absence of Congressional declaration to the contrary, purchases by cost-plus-fixed-fee contractors engaged on government contracts are subject to state and local sales taxes. The matter is now being considered by Congress.

Several factors suggest the desirability of permitting the states to tax these purchases. States are entitled to some compensation for services rendered to defense industries. Taxes under such circumstances are, to repeat the words of the court, "but a normal incident of the organization within the same territory of two independent taxing sovereignties." A distinction between sales taxes and other taxes applicable to government contractors appears unwarranted. Federal consent to state taxation of defense contracts is a comparatively desirable form of federal

aid to states. Moreover, a liberal federal policy in this respect would strengthen the government's case against the continuation of tax-exempt securities.

If the government were to assume ownership of the railroads few would contend that the states should go uncompensated for the loss of such a lucrative tax base. It seems doubtful if the pre-emption of the business of the automobile industry for war purposes differs in principle.

Finally, there is the tax-exempt security issue. Whatever may be concluded as to the merits of the argument concerning tax exemption of government bonds, there can be no doubt that the effort to eliminate this feature of our tax laws has met with constant, general, and bitter opposition from many state and local officials. It is the proposal to include the interest on state and local bonds in the base of the federal income tax which is most in conflict.

It is quite unfortunate that the two issues involved in the elimination of tax-exempt securities have become so badly confused. The proponents of exemption-elimination are not "out to deprive the municipalities of such limited fiscal advantages as the latter possess." Nor do most state and local officials take any pleasure in serving as a "front" to protect the patently unfair privileges of rich taxpayers. Some hope is entertained that these two groups might get together on some kind of a program which would meet the objectives of both.

Many suggestions toward this end have been made. Most promising politically, perhaps, is the suggestion that the federal government grant a direct subsidy to units which borrow in the future. The equivalent of one-half of one percent on the outstanding principal of new bond issues could be paid to the issuing units annually. This would have the effect of eliminating the inequities in the income tax created by tax exemption, and would convert a hidden and indirect subsidy into an open and direct one. If a compromise is necessary to secure action and promote better governmental relations, and such seems to be the case, this solution is recommended.

12. *Business Taxes*

The business tax sector of our tax system is marked by much confusion and many resulting possibilities of repressive effects upon the economy. The relative place of business taxation in our tax system is probably too large and this form of taxation should be "deemphasized." This objective would be facilitated were techniques developed whereby undistributed corporate income could be subjected to the personal income tax.

Much could be said for the exclusive taxation of business by the federal government, with the states sharing in the revenue on condition that state and municipalities retire from the use of capital stock taxes, insurance taxes, gross income taxes, corporate net income taxes, and other business taxes. Compliance costs resulting from diversities; injustices and losses of revenue owing to jurisdictional confusion; and the repressiveness of state forms of taxation support such a program.

A quantitative appraisal of what these causes for action add up to is not possible without research that cannot be attempted in an emergency period like the present. For the present, progress can be made in the di-

rection of joint administration of state and federal corporate income taxes, and closer federal-state co-operation in reducing diversities and mitigating multiple taxation. Federal incorporation of corporations engaged in interstate business is long overdue not only for the elimination of extra-territorial taxation but also to make effective the regulation of the corporate institution.

13. *Multiple Taxation*

The problem of multiple taxation is emphasized by recent court decisions which indicate that judicial limitations on multiple taxation are very substantially reduced. The quantitative volume of multiple taxation is a matter concerning which there is almost no evidence, a fact which suggests first-rate field for future study. But it is safe to say that the quantity is substantial and that the inequities involved are sometimes so great as to discredit the tax system. While the states can and should do something through reciprocal legislation to reduce the amount of multiple taxation, the main impetus for improvement will probably have to come from the federal government. This means some interference with state and local fiscal independence but in the long run it will support such independence. It is a case of having the finger off in order to preserve the arm.

The precise rules that should be applied and the means of promoting them must remain somewhat vague for the present but the outlines of a desirable procedure are fairly clear. They call for: (1) conference and consultation between federal representatives and those of the states as to acceptable uniform jurisdictional rules; (2) joint promotion of the adoption of these rules; (3) acceptance of federal arbitration in case of dispute; and (4) federal development of incentives for state compliance. The federal government should attempt to acquire the determination of state jurisdiction by means of favors and subsidies extended to the states. Present increasing multiple taxation acts as an unfortunate penalty upon cosmopolitan ownership of business, a sort of trade barrier, which it is the natural role of the federal government to prevent. It should not shirk its proper task in the matter.

14. *Local Fiscal Independence*

Most cities have been living from hand to mouth in the hope that something would turn up. What is needed apparently is some new source of local revenue which will (1) not overlap existing federal and state taxes, (2) enable the localities to tap their own resources without running hat in hand to central governments, (3) cover all or a vast majority of the interested citizenry, and (4) not be regressive. This is no easy assignment. It calls, we think, for a thorough reconsideration and re-examination of the general property tax. Among other possibilities, one that merits a great deal of attention is that of placing part of the property tax load upon the occupier. The frequency with which such taxes have been used by other countries suggests that they have possibilities that may well be explored. At any rate the municipality should be given greater freedom in the application of the general property tax.

15. *Fiscal Policy*

Time will not afford an extended discussion of the problems of fiscal policy, especially as they apply to the

post-war era and as they involve intergovernmental relations. The post-war period may be like the Twenties, in which case the problems involved will not be very troublesome. But we need to be prepared for another period like the Thirties with under-employment and under-investment a very serious problem. Under these circumstances it seems both inevitable and desirable that the government will underwrite the maintenance of a high level of economic opportunity and full use of resources and plant capacity in the United States. In so doing, it can and should greatly improve upon the experience of the Thirties. Public investments should be selected and budgeted so that they will pay for themselves, so far as possible, over the period of their own usefulness. Through direct collections from the beneficiaries of the investments, and indirect collections through the tax system, each item of outlay should contemplate a closed circle of outgo and intake. No shortage of projects which might be eligible for such procedure is likely, but the political discipline required is very great. The alternatives to a program of this character, however, are not attractive. There will be vested interests that would prefer to see public money invested in lines that are strictly "non-competitive." These vested interests must be either dissuaded or pushed aside. It is partly to retain a large part of our traditional private economy that plans like the above are proposed, and they should have the united support of those who are interested in preserving traditional values and in sane and orderly progress.

The need for wide federal powers in the application of fiscal policy support more centralization in the fiscal system. But considerable centralization has already occurred and a wholesale shift of powers is to be avoided, at least until a further co-operative attack upon the problem has proved inadequate.

16. *Conclusion*

It has been impossible to cover more than a few high points in this very large field of intergovernmental fiscal relations. It is not a field in which progress comes easily, and if any of the suggestions here made helps to develop some constructive action it will be adequate reward for our effort.

ROYAL COMMISSION ON DOMINION-PROVINCIAL RELATIONS

Intergovernmental Fiscal Relations in Canada

AN OUTSTANDING document on intergovernmental fiscal relations is the report by a Royal Commission on this subject in Canada, 1940.* The following selection is from this report. The "Plan I" referred to provided for exclusive national use of the personal income, corporate income, and death taxes, and the allowance of an adjustment grant, according to need, to the provinces.

Equity and Efficiency in Taxation

The Commission is directed by its terms of reference to examine whether taxation, as at present allocated and imposed in Canada, is as equitable and efficient as can be devised. The examination has been made in Book I [1] and reasons have been given for returning a negative answer to the question thus propounded. The financial plan recommended by the Commission as Plan I has been devised with a view to effecting some important improvements in the Canadian system of taxation and to making possible a thorough reform of that system in respect both of its equity and its efficiency. The purpose of the present chapter is to advance a number of recommendations and suggestions for reform and to show how the adoption of Plan I would make it possible to give effect to them. Equity and efficiency in taxation are closely related and in practice neither can be pursued without regard for the other. It will, however, be convenient to direct discussion in the first place to efficiency in taxation.

Efficiency in Taxation

Efficiency in taxation has been defined in Book I [2] as skill in collecting a given amount of revenue with the least possible burden on the national income. Taxation, taken together with the expenditure which it defrays, does not necessarily impair the national income. Indeed, the national income should be enlarged by the influence of the services which governments supply, and, if wise policies are followed, the form which the national income takes as a result of taxation and expenditure will be preferable to that which it would have taken had the functions of government been more restricted. While the present chapter is devoted to

[1] Chap. 8.

[2] *Ibid.*

* *Report of the Royal Commission on Dominion-Provincial Relations,* Book II, pp. 150–162.

equity and efficiency in taxation it must be remembered that it is equally important that governmental expenditures should also be governed by considerations of efficiency and equity. However, as the proportion of the total national income which is taken by governments rises, it becomes only too probable that taxes will be employed which seriously impede the expansion of the national income. In calculating the proportion of the income which is taken by governments their non-tax revenue in the form of licenses, liquor store profits and so forth must be included and, if social services are financed by compulsory contributions, these too must be counted.

Inefficiency of Taxation on Costs.—Generally speaking, the national income will be restricted if revenue is raised in ways which lead to an increase in production and business costs. To this general proposition there is an obvious exception in the case of taxes which appear to increase the costs of an industry but which, in so doing, merely operate to drag into the open and impose upon it concealed costs which had previously been borne by the public, e.g., taxes on vehicles which damage the roads, levies to provide compensation for those injured in industrial accidents, or to provide maintenance for those thrown out of employment. In these cases it is true that a marginal firm, or even a marginal industry, may be eliminated, but in the long run its disappearance should be socially beneficial, as it is likely to be replaced by a firm, or an industry, which can pay its way. Taxation which forces an industry to bear its legitimate costs will sometimes operate, just as minimum wage laws may operate, to destroy a substandard industry.

But, except in a special case of this character, it is very undesirable that taxation should eliminate either a firm or an industry by destroying the margin of profit which enables it to remain in operation. This is precisely what taxes which increase costs of production tend to do. Many firms and many industries are, no doubt, able to bear these taxes. But firms which are struggling to survive may find that taxes affecting their cost of production compel them to raise their prices, and that although their competitors also have to raise their prices, their sales fall off because of diminished consumption. In the long run these struggling, or marginal firms, may find that their business has become unprofitable or, worse still, that they can continue in business only at a loss. The result will be that marginal firms will tend to disappear and that other firms which had formerly had a comfortable margin of profit will in their turn become marginal. At the same time new enterprises will be deterred from entering a business in which costs have been raised by taxation, and consumption restricted by high prices. The result of the tendency of marginal firms to disappear and of the tendency of potential investors to refrain from engaging in new enterprises, is that both labour and capital resources will be thrown out of employment and that the national income will be correspondingly diminished. Out of this diminished national income a larger revenue than before will have to be raised, as the unemployed will have to be maintained at the public cost. If, in order to raise the larger revenue, new taxes are imposed which bear on costs, the vicious circle will be completed.

The alternative to taxes which in-

crease business costs lies in taxes falling on profits or other surpluses. In the long run this means that these taxes should be replaced by an expansion of the personal income tax. As an immediate measure they would presumably be replaced, in the main, by increasing the rate of tax on corporate income. This (which would result almost automatically from the implementation of Plan I) would in itself be a great step forward, for although the corporate income tax partakes of the character of a tax on costs it is paid only by businesses which show a net profit and imposes no burden whatever on enterprises which are unable to bear it. It would, therefore, occasion no diminution of the national income in the way which has been described. Nor should it exercise the same deterrent effect on new investment.

It has been shown in Book I[3] that in Canada a larger part of the total revenue of governments than in other comparable countries has been raised by taxes which increase costs, and it has been shown that this harmful taxation is not merely the result of a mistaken policy which can be changed at will, but that it is a practically inevitable consequence of the present allocation of the burdens of government and of the sources of revenue as between the Dominion and the provinces. The financial arrangements which the Commission has proposed in Plan I are designed to go to the root of the evil and to remove the basic obstacle to a sound fiscal policy. By relieving provincial governments of many of the charges which they now have to meet, and transferring these charges to the Dominion, Plan I makes it possible, and necessary, for the provinces to renounce the use of taxes on corporations, personal income taxes and succession duties. The Dominion, as the sole government employing these important forms of taxation, will then be in a position to give effect to substantial reforms, some of which will follow automatically from the unification of taxing authority.

In another chapter a list is given of the various taxes which provinces impose on corporations in addition to those which an individual or partnership carrying on the same business would have to bear. Many of these are taxes which increase the costs of production because they have to be paid even if no net income is earned by the corporation. In practice, it is service corporations —banks, finance companies, chain stores, investment companies, trust companies and loan companies— which have suffered most from taxes based on their capital stock, or on some other index which bears no necessary relation to their earnings. In their turn the chief victims have been the white-collared workers whom these companies would have employed if they had not been forced to close this or that office, or if they had been disposed to expand their operations. And unemployment cannot develop in any section of the highly integrated Canadian economy without tending to spread, by reason of the reduced consumption of the unemployed, to other sections of the economy.

The Dominion is in a far better position than the provinces, and than the Dominion and the provinces together, to sweep away all these objectionable taxes and replace them by increasing the rate of taxation on the net incomes of corporations. As has already been suggested

[3] *Ibid.*

this reform, while it would be important, should only be preparatory to a more radical change which would shift the burden of these taxes to the personal incomes derived from business (and, of course, from other sources too). Other taxes which increase costs, of which the sales tax is the leading example, could be gradually replaced by revenue derived from the two main instruments of progressive taxation—the personal income tax and the succession duties —if, as Plan I provides, these were employed by the Dominion alone. The same use cannot, in practice, be made of these taxes if both the Dominion and the provinces use them, for the imposition of a high rate of tax in one province makes it difficult for the Dominion to increase its own rates without causing great hardship to taxpayers in that province, even though there may be much to be said for higher rates of federal taxation so far as the other provinces are concerned. The importance of reforms which would replace taxes on costs by taxes on surpluses can hardly be over-emphasized, for it is largely through the avoidance of burdens on what have been described as marginal enterprises that more sustained employment of the nation's manpower and of the nation's capital can be achieved.

Inefficiency incidental to other repressive taxes.—Avoidance of burdensome taxes on costs with their repressive effects on employment is not the only objective at which an efficient tax policy should aim. It should seek to avoid other deterrents to desirable economic behaviour and, when possible, should provide incentives to desirable behaviour. The Commission has had occasion to point out how succession duties, as at present imposed by the provinces, operate to distort investment throughout Canada in a way which is economically undesirable. Uniform succession duties which would completely eliminate the evil of double taxation of the same property, and which would minimize the possibility of evading the tax, would make it possible to derive the maximum revenue from this source with the least harm to the national income. It is theoretically conceivable that this result might be obtained by a complicated interprovincial agreement coupled with appropriate Dominion legislation, but experience shows that close voluntary co-operation of this character is extremely improbable. Even if an agreement were made it might, in addition to its beneficial consequences, have the undesirable effect of making it difficult to adjust the details of the tax from time to time to suit changing conditions. Plan I, as has been shown, would both ensure complete uniformity and afford full opportunity to modify the structure of the succession duties as experience might show to be necessary for equity as between taxpayers and for efficiency in administration.

What has been said of succession duties has its counterpart in respect of the personal income tax. In this case, however, the imposition of the same tax by both Dominion and provinces (and even by some municipalities) is not a mere possibility but an accomplished fact. The freedom of action of the Dominion is seriously cramped when it has to find taxes which will operate without causing undue hardship either in provinces which have or in those which have not their own income tax. When the same citizen has to pay income taxes

to two authorities which have different definitions of taxable income, or which allow different exemptions, or which adopt different systems of progression, or between which there is dispute as to priority in assessment, he is likely to be a more than usually unwilling taxpayer. He feels that two different taxes cannot both be right, that they cannot both be the most equitable that can be devised. Almost certainly he will think of the one less unfavorable to himself as the more equitable. Uniformity in income tax structure is conceivable as a matter of agreement, but it is improbable. Under Plan I uniformity is automatic, since there will be only one personal income tax in all Canada, and the field will be clear for perfecting the tax.

From the point of view of efficiency in taxation (as well as from that of equity which will be considered later) it is important that the tax should be perfected. It has already been suggested that the aim should be to make the personal income tax take the place of the corporate income tax which partakes of the character of a tax on business costs. These two income taxes, as they are employed today, have as one of their results that investment income in the form of dividends is taxed twice while all other income (including investment income in the form of bond interest) is taxed once only.[4] The two taxes as now imposed make the income from corporate enterprise less vulnerable to taxation if the capital structure of the enterprise is largely composed of bonded debt. Yet this type of capital structure is hardly deserving of the encouragement which the Canadian taxation system extends to it, for the heavy fixed charges which it involves import a rigidity into the national economy which may be dangerous in times of depression. Nor is it expedient to penalize (as at present) corporate organizations as contrasted with partnerships, individual enterprises, and publicly-owned enterprises. It might be found practicable to obtain, by taxing income generally at a higher rate than at present, enough revenue to replace the revenue which would be forgone if dividends as an item in personal incomes were exempted to the extent of the tax paid upon them at the source as net corporate income.

* * * *

Inefficiency arising from high cost of tax compliance.—In another chapter the Commission has discussed the economies which can be made in the cost of tax collection through cordial and intelligent co-operation between governments. Under Plan I most of these economies would be secured automatically since, in respect of three important taxes, one taxing authority would be substituted for many. There remains to be considered the important question of the cost to the taxpayer of complying with the laws which impose taxation upon him.

Representations from business organizations placed such emphasis on the cost of tax-compliance that the Commission attempted to secure some measure of this burden. Through the facilities of the Canadian Manufacturers' Association, a questionnaire was circulated among

[4] As a matter of equity there is no clear reason why bond interest should have been accorded this favoured position; and as between two recipients of dividends the combined effect of the two income taxes is somewhat regressive in comparison to the alternative type of taxation.

about 100 Canadian firms constituting a representative cross-section of Canadian industry. In the hope of obtaining fuller and franker information than might otherwise have been supplied, the firms were not asked to make their identities known to the Commission. The replies were received by the Canadian Manufacturers' Association and a code number affixed. Copies of the information were then forwarded to the Commission's office at Ottawa. About seventy replies were received. The information came from firms ranging in size from those whose office staff consists of one person only to some of the giant corporations of the Dominion. The information thus secured included not only the costs of tax-compliance but also costs on industry arising from compliance with government inspection, audits, statistical returns, etc. The answers to the questionnaire disclosed a wide variation from one firm to another depending upon the volume of business done, the nature of the business, the geographical scope of its operations, and the care taken in filling in the returns. It is not possible to reach conclusions applicable to all companies nor is it possible to arrive at a monetary estimate of the gross burden on all corporations but certain general conclusions may be stated. For a small company with a restricted geographical scope of activity, the burden is very small and perhaps not unreasonable; the principal complaints of such companies were that extra work was required and time was taken which might have been better devoted to more productive work. For large companies whose operations expose them to the full impact of Dominion, provincial and municipal regulations, taxing statutes and collections of statistics, there is a material extra burden imposed. One very large corporation estimated that its annual cost of preparing government returns was $90,000; it was required to file annually twenty-nine returns to the Dominion Government, sixty-four returns to seven provincial governments, and seven municipal returns, and it was subject to fifty audits and inspections; an additional staff of thirty-three persons was needed to prepare these returns. In addition to the actual out-of-pocket costs the larger companies emphasized the loss in productive capacity caused by diverting time and energy of responsible officers from the development and improvement of the business to the supervision of tax-compliance, or collection of data. Certain of the answers also stressed the difficulties created by divergences between Dominion and provincial requirements as to information required for their respective returns. For example, the lack of uniformity in depreciation allowances may require considerable extra work in preparing quite separate depreciation schedules. The answers also mention the loss of time and disruption of business caused by duplication in audits by different units of government.

These complaints deal with a number of distinct matters and raise some ancillary questions. In the first place there is the cost of preparing the returns required by governments for the purpose of calculating the taxes payable by the business. This expense is in itself a sort of taxation although the amount may be difficult to estimate. Efficiency in taxation requires that it should be reduced to the very minimum and the Commission believes that a substantial re-

duction would result from the adoption of the recommendations of Plan I looking to the replacement of the numerous taxes on corporations by a single tax on net corporate incomes.

In the second place, there is the cost to business of the audits designed to test the accuracy of the returns. Governments, to keep their own costs of collection low, are apt to require audits at times inconvenient to business and sometimes long in arrear. The proposals of Plan I would, if adopted, lead to a reduction in the number of audits, since there would be no further occasion for audits by provincial governments which would withdraw from the taxation of corporate income. A single taxing authority would be in a better position than ten potential taxing authorities for arranging audits in a convenient and inexpensive form and for endeavouring to avoid the evil, of which the Commission received complaint, of reopening assessments years after the event and demanding financial readjustments in cases in which there was no accusation of fraud. Some of the hardships complained of may have been incidental to the elaboration of a new form of taxation. A single taxing authority is in the best position to apply quickly and intelligently the lessons of experience.

In the third place, there is what might be termed the cost of tax avoidance. No one wishes to pay more than the law requires. Taxation statutes are often drawn in great detail but their effect is not always crystal clear. Sometimes the amount which a business is required to pay can be substantially reduced by the exercise of care in its accounting practices and by the arrangement of details of the business. From the point of view of the business the cost of obtaining skilled advice and making the adjustments indicated is part of its tax burden since it is an expense which would not be necessary but for the imposition of the tax. From the point of view of the government imposing the tax these expenses may at times appear as incidental to an effort to escape from a legitimate burden. But from any point of view it is regrettable that there should be occasion for them. The proposals in Plan I, by reducing the number and complexity of taxing statutes, should do something to reduce these expenses, although it is impossible to eliminate them altogether.[5]

In the fourth place, governments demand a great deal of information from businesses which is not concerned directly, or even at all, with taxation. In the survey conducted by the Commission little distinction was made by businesses between returns required for purposes of taxation and returns incidental to other matters. It seems probable that business men treat both types of return as but different species of the same genus, namely governmental interference. This attitude is the easier to take because there seems to be widespread scepticism as to the value of much of the statistical information which governments collect. Yet much of the information is necessary for governmental purposes and useful for industry as a whole.[6] The Commission suggests that a special effort should

[5] For complaints as to number of taxing statutes see Ex. 88, Brief of Canadian Manufacturers' Association, Ev. p. 2315. [References to *Report of Proceedings* are cited Ev.; references to Exhibits are cited Ex.]

[6] E.g., trade statistics, accident statistics.

be made by statistical branches to place before the industries concerned, at the time when information is requested, the value of the compilations which will be made possible by their co-operation—a co-operation which does involve a certain expense to business. It is always possible that in the course of preparing a justification for a return it may be found that it is no longer of practical importance, in which case the contemplated demand on business need not be made.

It will be seen that the major reductions in the cost of tax compliance are dependent on the adoption of Plan I and are not possible either under present conditions or under Plan II. It is, therefore, necessary for the Commission to add that, if Plan I is not adopted, there should be close voluntary co-operation between Dominion and provinces with a view to using common returns and common audits wherever this is practicable and to combining returns so as to minimize the cost to industry.

Equity in Taxation

It must be the wish of every thoughtful citizen that as far as is humanly possible the burden of government should be justly distributed and that every citizen should realize that he is making a just contribution —no more and no less—to the common expenditures. Taxation moreover cannot be efficient if it is grossly unfair and if two citizens, similarly situated, are called on for grossly unequal contributions to the cost of government. From the standpoint of the efficient tax-gatherer the less heavily taxed of the two might be required to pay more. From the standpoint of the taxpayer the more heavily taxed of the two is being victimized. Taxpayers are most willing to pay when they can see that they are getting value for their taxes. In so far as they are contributing to the deadweight costs of governments, taxpayers are most willing to pay if they believe that they are being asked for no more than their fair share of a common expenditure. It is, therefore, essential to efficiency in taxation that taxpayers should be convinced that the taxes exacted from them are taxes which it is fair that they should pay and which it would be unreasonable for them to grudge. But it is hard to find a canon of taxation which would be generally acceptable and it would be hard to apply any canon to the intricate mass of taxation which exists in Canada today. Any individual tax can be criticized on the ground of equity only if it operates unequally as between two citizens in substantially similar positions. When the system of taxation is considered as a whole it would, no doubt, be significant if it could be related to the income of each citizen so as to show what percentage of his income each man pays. But our taxes are very complicated and the incidence of many of them is likely to shift, so that the person who pays a tax in the first instance may not be the one who eventually bears its weight. It is, therefore, impossible to say with confidence what weight of taxation any one taxpayer bears. Nor is it possible to compute what his net income would have been had the tax system been different from what it is.

* * * *

Equities as between Individuals.—Subject to such reservation as may have to be made on these grounds of public policy, it is arguable that the

tax burden should be so apportioned that every citizen will contribute according to his ability. This doctrine may be understood in various ways. It may mean that each citizen should contribute a uniform percentage of his income; or that he should contribute a uniform percentage of his income after deducting the minimum cost of his maintenance and of that of his dependents; or that he should contribute a higher porportion of this surplus if it is large than if it is small. The third version of the doctrine embodies the principle of progression. It is in accordance with the idea that equality of sacrifice is what should be sought, and not far removed from the idea that the necessary revenue should be raised with the least aggregate sacrifice to the citizens. Even among those who agree that progression is desirable there is no agreement as to the optimum rate of progression.

In practice no system of taxation can claim to conform to these exalted principles, the strict application of which would condemn any form of taxation (unless partaking of the character of a price or of a fine) which fell upon incomes so low that they provide a bare subsistence for those dependent on them for support. But principles which cannot be rigidly applied may, nevertheless, serve as a guide.

As far as possible no taxation should be imposed on the necessary minimum expenditures of low income groups. If, as was contended in some of the submissions, all citizens should be made tax conscious in order that a sense of civic responsibility might be fostered, this result can best be achieved by taxes on minor luxuries such as tobacco. In Canada there are some consumption taxes which do fall on low income groups and if these groups are in the future required to pay social insurance premiums it will be important that the taxes which they now bear should be reduced or removed. In the meantime these taxes may be regarded to some extent as a means of payment for essential services rendered to these groups by the state and, therefore, as being, in a broad sense, a price paid for necessaries.[7] This argument is the only possible justification for municipal taxes which increase the cost of the minimum of shelter, though it must be conceded that it is not clear that if taxes on cheap housing were removed the benefit would be immediately passed on in the form of lower rents any more than it is clear that increases in existing taxation would be passed on in the form of higher rents. In theory, however, this would be the case and it is reasonable to expect that, in the long run, there will be a dominant tendency in this direction. Some municipalities do make an attempt to exempt minimum housing requirements from the full burden of the taxation of real estate and further moves in this direction would appear desirable.

Very few taxes lend themselves readily to systematic progression and, if it is desired that the total weight of taxation should progress at a given rate, these taxes will have to progress at a much greater rate. In Canadian practice the two main progressive taxes—the personal income tax and succession duties—are imposed at very high rates on very large incomes and very large estates and exact far

[7] A similar argument could be used if universal non-contributory old age pensions were financed by a sales tax, the incidence of which appeared to be highly regressive.

less from medium incomes and medium estates than do similar taxes in Great Britain, Australia, and New Zealand. The result is that while Canadian taxation is probably progressive as between medium and large incomes it is possibly regressive as between small and medium incomes.[8] From the standpoint of equity this distribution of taxation seems objectionable and the two taxes which are under consideration could easily be adapted so as to readjust it. But a discussion based on equity and efficiency in the narrow sense would be incomplete if it did not indicate that other considerations may enter into the determination of a tax policy. For instance, large incomes and large estates may be considered as undesirable in themselves and may be taxed accordingly. Heavy taxation may, in this case, be treated as something which will have a stabilizing and democratizing effect on the community, while similar taxation of the preponderantly important class which enjoys medium incomes might be thought of as socially dangerous. Or it may be considered that the taxation of large incomes and large estates may (without being unjust) be so high as to harm the national income by discouraging both exertion and investment. In either of these cases considerations of equity would normally be modified in the interests of over-riding considerations of public policy.

Inequities as between different regions of Canada.—With these general considerations in mind the more serious inequities of Canadian taxation, as at present allocated and imposed, can be considered. The most glaring inequity is territorial. If the taxes which the citizens of each province pay (including taxes paid to the Dominion, taxes paid to the province, and taxes paid to municipalities and other taxing authorities created by the province) are expressed as a percentage of the total income of the area concerned, it has been shown in Book I[9] that this percentage differs greatly as between provinces and that it is highest in the least wealthy provinces. The differences are even greater if the total taxes paid in each province are expressed as a percentage, not of the total, but of the surplus income of the province, i.e., of the total income less the cost of subsistence of the inhabitants. The whole structure of Plan I is designed to reduce (though Plan I will not eliminate) this inequality. Under the Plan each provincial government would be in a position to provide, either directly or through its municipalities and other agencies, normal educational, social, and developmental services for its people without having recourse to exceptionally heavy taxation. Differences in taxation might well continue but they would correspond to differences in the services provided. To realize this result as between provinces it is essential that the two taxes which lend themselves most readily to progression should be entrusted to the Dominion Government alone and should be made uniform throughout Canada. It is in this way only that money can be found for the National Adjustment Grants, payable to the provinces whose need is great, without resort to types of taxation which would nullify the very purpose of the grants. Just as in the discussion of efficiency in taxation questions of equity arose, so this arrangement, which conforms to standards

[8] Book I, Chap. 8.

[9] *Ibid.*

of equity, has marked advantages from the point of view of efficiency. The maintenance of the national income of Canada requires that every government in Canada should provide adequate developmental, educational, and social services for its people. This is not reasonably possible today. Plan I would make it possible. But Plan I cannot produce these consequences unless the provinces proceed to effect, as between various areas within the province, the same sort of equalization that Plan I would produce as between the provinces. At present neighboring municipalities performing similar services for their citizens frequently have very different rates of taxation and it is very inequitable that these differences should persist. If Plan I is implemented, provincial governments will be financially able to deal with this situation.

Questions of Equity and Efficiency relating to Particular Taxes.—In the course of the public hearings many representations were made to the Commission concerning the inequity or inefficiency of particular taxes as at present imposed, and some further suggestions have occurred in the course of the Commission's work. In this connection specific recommendations do not appear appropriate as many conflicting considerations are involved, some of which the Commission is not in a position to appraise. Discussion of a general character may serve two purposes: it may call attention to a number of grievances; and it may indicate the need for constant vigilance in adapting taxes to changing conditions.

In connection with the personal income tax it is frequently contended that it is unfair, or even unjust, to tax an individual on that part of his income which he has already paid by way of income tax to another taxing authority. This is what happens in the Western Provinces and on large incomes is a very important factor. The following table shows the percentage of the gross income taken by the provincial income tax in British Columbia and Alberta, where the income tax paid to the Dominion is not allowed as an exemption, and, in contrast, the proportion taken in Ontario, where the provincial rate is half the Dominion rate, but where the income tax paid to the Dominion is allowed as an exemption:—

PROVINCIAL INCOME TAX—PROPORTION OF GROSS INCOME

(Married man with no dependents—prior to September, 1939 Dominion Income Tax Increase)

Income	British Columbia	Alberta	Ontario
$100,000....	23%	26%	7.4%
500,000....	27%	29%	7.8%
1,000,000....	27%	30%	7.7%

This grievance results from the existence of Dominion and provincial income taxes neither of which concedes priority to the other. It would disappear automatically if Plan I were adopted. At present some provinces complain that they must perforce concede priority to the Dominion income tax [10] and, if they do so, the taxpayer's grievance does not arise. In practice neither the grievance of the individual nor that of the province is much alleviated by pointing out that a careful readjustment of the rates of tax could raise the same revenue from the same people without taxing anyone on in-

[10] Ex. 296, Brief of Ont., Pt. I.

come which he had already paid in income tax. If Plan I is not adopted there is, however, much to be said for making some such readjustment.

* * * *

Some of the many and varied problems which arise out of the taxation of real estate have been discussed in another chapter. No taxes have been more bitterly denounced and it is the hope of the Commission that an indirect effect of the adoption of Plan I would be to reduce the burdens which these taxes have to carry, to facilitate some readjustments as between municipalities, and consequently to make it possible to carry out some of the reforms which are suggested in the chapter on municipalities.

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JAMES W. MARTIN

Costs of Tax Administration and Compliance

AS PREVIOUSLY pointed out, a major objective in coordinating federal and state taxes is a reduction in the costs of dual tax compliance and administration. Some idea of the volume and nature of these costs is indicated in the following selection: *

* * * *

The General Situation

No generalized, quantitative conclusions can be reached from the illustrations that have been presented. Incomplete data from about a dozen other large corporate taxpayers have been secured, and they tend to support the showings in the summary table; but so few cases give no statistically valid basis of general estimate. If, however, these scattered data be examined in conjunction with Professor Haig's findings [1] and with other published and unpublished statistics from scattered sources, and in the light of informed judgments by those who handle corporate tax payments,[2] certain propositions, supported by some evidence, can be stated. Whether these would be equally applicable to small-scale taxpayers, one has no way of knowing.

1. Costs of tax compliance are highly variable. The differences are of several sorts, among which are

[1] Robert Murray Haig (with the assistance of the American Management Association), "The Cost to Business Concerns of Compliance with Tax Laws," *The Management Review*, XXIV (Nov. 1935), 323–333.

[2] About 50 of whom have been interviewed.

* "Costs of Tax Administration: Examples of Compliance Expenses," *Bulletin of the National Tax Association*, XXIX, No. 7 (April 1944), 194–205.

those due to character of business, to kinds of tax, to differences of state policies, and those dependent on whether the tax is imposed at the federal or the state level. It is believed, but without significant factual support, that differences in taxpayer size, within certain limits, may be a determinant of tax compliance costs; that individual taxpayers of the same general class incur varying costs, depending, e.g., on plan of administration used, extent to which a policy of avoidance or evasion is adopted, degree and character of political activity engaged in by principal officers (in particular jurisdictions), and other variables; and that different forms of business units may have different costs. Even the restricted examples tabulated here adequately support the variability of taxpayers' costs of meeting tax law requirements. Haig's study is still more eloquent on this point.

2. The meager evidence available tends to show that pay-roll tax compliance costs are higher than the average of all compliance costs. They are not as high on the other hand, as some recently circulated rumors would lead one to believe.[3] One may assume that, whereas current income levels as compared with those of 1934[4] would lead to lower current unit compliance cost than for that year, the cost averages more per dollar of tax paid than would have been the case but for the initiation of payroll taxes.

3. Federal compliance costs in 1940 and 1941 were probably lower than state and local costs. Certainly state advantages, if any, are less than in 1934, the year on which Haig's study was based, because (a) with large incomes the cost per dollar of tax of conforming with federal income tax requirements is reduced; (b) states are now utilizing the payroll taxes, the costs of meeting the requirements of which are relatively high; and (c) the reduction in the relative proportion of state and local revenues derived from the property tax, a tax of low compliance cost, reduces the states' advantage. Even in the case of certain corporation executives who presented figures that seemed to show the contrary, there is an expression typified by the following passage quoted from a reaction selected at random.

> . . . Our reaction very definitely is that once there is a tax of a certain kind imposed at one government level there is very little additional cost involved in complying with a similar tax at another government level. For example, the voluminous continuation sheets required to be attached to state unemployment compensation returns are merely carbon copies of the Federal return. As another example, it is well known that state income taxes are computed and based almost entirely upon taxable net income as first determined for Federal tax purposes.

This view is expressed even more emphatically by numerous corporate executives looking after tax liability who have assembled no exact quantitative data.[5]

[3] Although the data available tend to confirm the facts cited by Shoup, they do not indicate an average cost as high as some critics infer from his examples. See Carl Shoup, *Prospects for a Study of the Economic Effects of Payroll Taxes* (Washington: Pamphlet Series No. 9, Social Science Research Committee on Social Security, 1941), p. 8.

[4] The year as of which Haig's study was made.

[5] One corporate tax executive, who was good enough in behalf of the present project to discuss the problem with several cor-

Approximating Compliance Costs

In order to approximate aggregate expenses of tax administration, public and private, it is essential to give quantitative expression to tax compliance costs. Only thus may the expenses to government be added to those privately incurred and an estimate rendered possible of the amount which each tax takes out and keeps "out of the pockets of the people . . . over and above what it brings into the public treasury of the state." [6]

poration tax commissioners, summarized the results as follows.

"In so far as large corporations are concerned, the prevailing opinion seemed to be that the administrative cost of complying with the tax laws is such a small fraction of the total tax cost that there would be no appreciable saving by consolidation of federal, state or local tax laws. Tax charges have become such an important item that most corporations of any size have been compelled to set up rather extensive departments to administer them and such duplications as exist between State and Federal laws do not affect this administrative cost appreciably. Although I made no inquiries of smaller companies, I presume that it would be quite a different matter with them and that the necessity of filing additional returns or complying with tax laws in overlapping jurisdictions would be more of a burden.

"Furthermore, there seemed to be a feeling that it would be a very dubious benefit to business to reduce the cost of compliance with tax laws if such reduction were brought about by further federalization of taxation. If the remedy for administrative burdens were to have the effect of promoting the trend toward centralization of government, the sentiment seemed to be that it would be a high price to pay for any saving in administrative cost. I use the words 'feeling' and 'sentiment' advisedly as no one stated the proposition in exactly the words which I have adopted, and my statement is merely a paraphrase of what I understood the aggregate opinion to be."

[6] Adam Smith, *Wealth of Nations* (Cannan ed.), Vol. II, pp. 311–312.

Data for an estimate of tax compliance costs, as already indicated, are lacking. However, in Table XXI guesses are made at these for the principal federal and state taxes. The guesses are not based on enough dependable data in each case to justify reference to the figures as *estimates*. Nevertheless, it is appropriate that some explanation of the basis for the attempted approximations [7] be given. The study by Professor Haig [8] is drawn upon heavily. But, as his investigation was made as of 1934, a depression year, and the present effort is to ascertain costs as of 1941, a prosperous year, adjustments are necessary. The adjustments used take account of increases in both number of tax returns, a cost-adding factor, and the volume of tax payments, a cost-reducing factor if expenses are couched in terms of costs per dollar collected. The result is averaged with the scattered new data—double weighting the latter as currently more dependable. It is remarkable that, aside from property tax compliance figures, the differences between the Haig data and the new figures are minor. Even as to property taxes they are comparatively unimportant. Possibly the variation in this case may result from inadequate distribution among classes of taxpayers either in Professor Haig's statistics or in the figures newly assembled.[9]

[7] Emphasis is placed on the probable inaccuracy of these figures. They are shown not as an attempt to define magnitudes but in an endeavor to help toward a *conception* of the total public and private administrative costs.

[8] *Loc. cit.* The other references in the remainder of this installment are to the same work.

[9] As in Professor Haig's experience, some of the information currently supplied was of doubtful usefulness.

TABLE XXI

COMPLIANCE COST GUESSES, 1941

	Revenue (thousands of dollars)	Hypothetical cost of compliance (cents per $1.00)	Total compliance cost (thousands of dollars)
Federal taxes			
Alcoholic beverage	$820,056	0.4	$ 3,280
Capital stock	166,653	0.9	1,500
Corporation income	1,860,356	1.3	24,185 [a]
Employment	925,856	2.9	26,850
Excess profits	192,385	0.5	962 [b]
Estate and gift	407,058	1.5	6,106
Individual income	1,418,383	1.2	17,021
Manufacturers and retailers	617,354	1.6	9,878
Miscellaneous	224,874	2.1	4,722
Stamp	39,057	0.5	195
Tobacco	698,077	0.5	3,490
State and local taxes			
Alcoholic beverage	408,869	2.4	9,813
Death and gift	116,351	1.6	1,862
Employment	875,558	3.0	26,267
Gasoline	934,337	0.2	1,869
Income, corporation, and personal	408,867	3.2 [c]	13,084 [c]
Insurance premium	89,033	0.3	267
Property	4,969,897	0.9	44,729
Sales	545,594	2.3	12,549
Tobacco	106,374	0.5 [d]	532 [d]

[a] Nearly $4 million added as assumed cost of compliance for corporations not making a taxable income.

[b] About $168,000 added as assumed expenses incurred when no tax is paid. The extraordinary cost of general initial study for profitable corporations is ignored.

[c] Includes provision for no-pay returns.

[d] Reflects net after credit for discounts to compensate for affixing stamps. Note that this method differs in principle from that invoked in reporting public administrative costs.

But the Haig statistics did not include all classes of federal and state taxes. In those cases in which no significant earlier figures are available, the present guess is based on totally inadequate current experience. Some of the figures are substantially "pulled out of the hat." This is especially true as to most of the federal miscellaneous excises and the federal and state alcoholic beverage taxes. It is substantially true also of the minor state revenues. No basis whatever has been discovered for approximating costs of compliance with motor vehicle registration and some other comparatively unimportant excises or with miscellaneous local revenue measures. These are simply ignored in Table XXI.

Magnitude of Administrative and Compliance Costs

If the figures developed in Table XXI approximate the actual cost to taxpayers of complying with the

principal taxes, then Table XXII depicts the grand total cost of tax administration, public and private. Although the actual cost to the public of administering the taxes may be greater than the figures estimated, or there is possibility it may be less, the $282 million total is predicated on some considerable statistical basis.[10] On the other hand, a statistical basis for the tax compliance total of just under $210 million is lacking. Thus, one may say that Table XXII shows in part the kind of result one might expect to develop if a compliance cost study were prosecuted. Whether the actual result of such investigation would exhibit a total compliance expense of $150 million or $300 million one can only guess.[11] The aggregate cost, public and private, then, may be considerably more or less than the half a billion suggested by the table.

Whether Haig's provisional conclusion that taxes showing low administrative costs exhibit high costs of compliance is borne out by the showing of the same and other data for 1941 is open to question. Certainly in the case of the federal tobacco excise, both public and private unit costs are especially low as is also true of both state and federal gasoline taxes. On the other hand, there is little reason to question Haig's theory in relation to corporation income taxes; though possibly there may be as applied to excess profits taxation—the latter an area concerning which Haig, of course, had no 1934 information. As to the individual income tax, the administrative cost is higher. The only considerable modification in the Haig tentative finding regarding property taxation is that the administrative cost data at hand indicate a lower figure than he assumed. The general import of his conclusion, however, that property taxes involve substantial administrative costs and low compliance expenses is apparently not subject to question. The pay-roll taxes seem also to conform with Haig's view. Although administrative expense of this simple class of revenue measures is moderate—in the case of state taxes perhaps not as low as one might have expected—the compliance is high.

Haig's conclusion that tax compliance costs are higher for businesses incurring liability in several states than for those which are local is sustained by the meager additional data. However, whereas Haig seemed to think this circumstance was an outgrowth of administrative policies the information at hand suggests strongly that it is caused by the expenditures which do not vary with the size of the bill. Thus, the taxpayer having far-flung interests must incur higher costs per dollar of tax paid because his liability to each tax collector is relatively low. In the absence of concrete evidence, it may

[10] From installment 2 it is seen that costs of administering all the principal state revenues, except perhaps property taxes, and all the federal internal revenues are estimated on the basis of comparatively dependable statistics. The estimates of local tax administration expenses, though based on something more than guesswork, leave much to be desired. In nearly all cases, it will be recalled some costs are not included.

[11] Probably the total figure shown as a guess is more likely to be low than high because (a) it omits important cost-of-compliance areas; (b) so far as it is factually based, it is predicated on the experience of large concerns which *may* enjoy considerable economies of large-scale production; (c) there is reason to think that a more refined method of gathering statistics would lead to higher estimates. See *Bulletin of the National Tax Association*, February, 1944, pp. 145–147.

TABLE XXII

HYPOTHETICAL AGGREGATE PUBLIC AND TAXPAYER COSTS OF TAX ADMINISTRATION, 1941 (in thousands of dollars)

Kinds of taxes	Public administration expense (estimate)	Compliance costs (guess)	Hypothetical aggregate
Total (federal and state)	$282,136	$209,161	$491,295
Federal			
Alcoholic beverage	$13,641	$3,280	$16,921
Capital stock	842	1,500	2,342
Corporation income	13,233	24,185	37,418
Employment	6,329	26,850	33,179
Excess profits	1,880	962	2,842
Estate and gift	2,100	6,106	8,206
Individual income	23,875	17,021	40,896
Manufacturers and retailers	590	9,878	10,468
Miscellaneous	1,314	4,722	6,036
Stamp	245	195	440
Tobacco	1,241	3,490	4,731
Total	$65,290	$98,189	$163,479
State			
Alcoholic beverage	$7,771	$9,813	$17,584
Amusement	1,678	.....	1,678 [a]
Bank	1,678	.....	1,678 [a]
Chain store	266	.....	266 [a]
Death and gift	2,094	1,862	3,956
Employment	8,019	26,267	34,286
Franchise or corporate stock	1,678	.....	1,678 [a]
Gasoline	4,672	1,869	6,541
Income	6,133	13,084	19,217
Insurance premium	4,291	267	4,558
Miscellaneous and license	25,200	.....	25,200 [a]
Motor vehicle	35,226	.....	35,226 [a]
Margarine	75	.....	75 [a]
Poll (state)	75	.....	75 [a]
Property	105,362	44,729	150,091
Sales	10,912	12,549	23,461
Severance	75	.....	75 [a]
Soft drinks	75	.....	75 [a]
Stock transfer	75	.....	75 [a]
Tobacco	1,489	532	2,021
Total	$216,844	$110,972	$327,816

[a] Do not include hypothetical compliance costs.

be assumed that a local taxpayer having a similarly small bill in a particular state, as many business executives interviewed[12] have suggested, would have as high, or about as high, a cost of compliance per dollar of tax. The relative insignificance of the tax bill, despite low cost of compliance, means that the taxpayer's expense of ascertaining and discharging his liability is high *as compared with the payment.*

The data presented in Table XXII, however, perhaps fail to justify even such provisional inferences as these. The general conclusion that *does* seem justified is that the total public and private costs of getting taxes from taxpayer to the public treasury aggregate for the former a total which approaches $300 million, and for the latter an additional large but unknown sum, which, however, probably exceeds $200 million and which thus may bring the total to the vicinity of half a billion dollars. This tax cost is, of course, additional to the net tax revenues (after costs of administration) collected by federal, state, and local governments.

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[12] See James W. Martin, "Efficiency of Personnel in Tax Administration," *Taxes—The Tax Magazine,* Feb. 1944, pp. 50 ff.

CHAPTER 10

PUBLIC EXPENDITURES

MANY treatises on public finance begin with some analysis of public expenditures, the reason for the priority apparently being that if we spent no money, we would need to raise none. In other words, public expenditure in a sense is the villain in the piece. Usually it is observed that within recent years public expenditures have tended to advance both absolutely and relatively (to national income), and an attempt is made to account for the advance.

Proceeding somewhat more fundamentally, one may begin with various views concerning the place of government in the scheme of things. Here he finds the classical views of the *"laissez-faire"* economists at one extreme and the views of socialists and planners at the other. The trend has been strongly toward the predilections of the latter.

Another approach to public expenditure is by analysis of its economic effects—on production, consumption, and distribution.

Concerning specific outlays for government, attention is turned to the large and increasing costs of wars. During wars, public-expenditure problems center about the supply of equipment and ammunition for the fighting forces; after wars, the problems of war debt and pensions become pressing. And there are also future wars for which to prepare. All of this seems peculiarly wasteful to many critics who are impatient for the day when nations can feel secure without armaments.

Expenditure for education also rates high in public budgets. Some analysis of the economic effects of education seems essential. Public works, including highways, are also important. Here we encounter the new interest in using public works as a compensatory device to cope with business cycles. Public-welfare outlays rose to great proportions during the depression of the thirties and developed an impressive array of institutions and problems, some of which have carried over into later eras of full employment.

Government economy takes several forms, one of which consists of efficient management. Those who are the best friends of government should be the hardest critics of its performance. Wastes in the manage-

ment of personnel and in the survival of antiquated, excessive, and uneconomic units of government are among those needing constant attention.

An important expenditure institution involving the transfer of funds from one level of government to another is that of our state and federal aids. The latter have developed often with inadequate attention to objectives and with insufficient coordination of the various aids.

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ADAM SMITH
JOHN STUART MILL

The Functions of Government

THE BREADTH of public expenditures depends first of all on how ambitious a role we expect the state to play. Adam Smith and John Stuart Mill expressed the classical view that the state can and should be confined to a very limited scope. The following digest of the views of these two economists is ably presented by Charles J. Bullock: *

4. *The Views of Smith and Mill concerning the Functions of Government.*—Adam Smith formulated his views in the following passage: [1]

"According to the system of natural liberty, the sovereign has only three duties to attend to; three duties of great importance, indeed, but plain and intelligible to common understandings: I. the duty of protecting the society from the violence and invasion of other independent societies; II. the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and III. the duty of erecting and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain, because the profit could never repay the expense to any individual or small number of individuals, though it may frequently do much more than repay it to a great society."

The doctrine that, beyond providing for external defense, affording legal protection, and undertaking a few indispensable public works, the

[1] *Wealth of Nations*, Book IV, Chap. 9.

* From *Selected Readings in Public Finance* (3d ed.; Boston: Ginn and Company, 1924), pp. 11–19. Reprinted by permission of Ginn and Company, publishers.

government should not interfere with the affairs of its citizens has often been called the doctrine of *laissez-faire*. In the middle of the nineteenth century, when its influence was perhaps greatest, the theory was formulated in moderate and effective form by John Stuart Mill. At the outset Mr. Mill remarks[2] that "there must be a specification of the functions which are either inseparable from the idea of a government, or are exercised habitually and without objection by all governments; as distinguished from those respecting which it has been considered questionable whether governments should exercise them or not. The former may be termed the *necessary*, the latter the *optional*, functions of government.

The *necessary* functions of government recognized by Mill are substantially the same as those recognized by Adam Smith, although the latter writer does not draw the line of demarcation quite so sharply as the earlier. In fact, Mill says:

"In attempting to enumerate the necessary functions of government, we find them to be considerably more multifarious than most people are at first aware of, and not capable of being circumscribed by those very definite lines of demarcation, which, in the inconsiderateness of popular discussion, it is often attempted to draw round them. We sometimes, for example, hear it said that governments ought to confine themselves to affording protection against force and fraud; that, these two things apart, people should be free agents, able to take care of themselves; and that so long as a person practices no violence or deception, to the injury of others in person or property, legislatures and governments are in no way called on to concern themselves about him. But why should people be protected by their government, that is, by their own collective strength, against violence and fraud, and not against other evils, except that the expediency is more obvious?"

* * * *

"There is a multitude of cases in which governments, with general approbation, assume powers and execute functions for which no reason can be assigned except the simple one, that they conduce to general convenience. We may take as an example the function (which is a monopoly too) of coining money. This is assumed for no more recondite purpose than that of saving to individuals the trouble, delay, and expense of weighing and assaying. No one, however, even of those most jealous of state interference, has objected to this as an improper exercise of the powers of government."

* * * *

"But enough has been said to show that the admitted functions of government embrace a much wider field than can easily be included within the ring-fence of any restrictive definition, and that it is hardly possible to find any ground of justification common to them all except the comprehensive one of general expediency, nor to limit the interference of government by any universal rule save the simple and vague one that it should never be admitted but when the case of expediency is strong."

In a subsequent chapter[1] Mill considers the optional functions of government, and presents his reasons for believing that in the civilized countries of modern times the scope

[2] *Principles of Political Economy*, Book V, Chap. 1.

[1] *Op. cit.*, Book V, Chap. 2.

of governmental activity should be limited as narrowly as possible. In the first place, he says, governmental interference with economic affairs generally involves compulsion, which is unpleasant in itself, and, by preventing men from acting according to their own judgment, tends "to starve the development of some portion of the bodily or mental faculties." Then, too, governmental action usually involves expense, which must be defrayed out of compulsory contributions levied upon the persons or property of citizens. Mill then continues:

"A second general objection to government agency is that every increase of the functions devolving on the government is an increase of its power, both in the form of authority and, still more, in the indirect form of influence. The importance of this consideration, in respect to political freedom, has in general been quite sufficiently recognized, at least in England; but many, in latter times, have been prone to think that limitation of the powers of the government is only essential when the government itself is badly constituted; when it does not represent the people, but is the organ of a class, or coalition of classes; and that a government of sufficiently popular constitution might be trusted with any amount of power over the nation, since its power would be only that of the nation over itself. This might be true, if the nation, in such cases, did not practically mean a mere majority of the nation, and if minorities were only capable of oppressing, but not of being oppressed. Experience, however, proves that the depositaries of power who are mere delegates of the people, that is, of a majority, are quite as ready (when they think they can count on popular support) as any organs of oligarchy to assume arbitrary power and encroach unduly on the liberty of private life. The public collectively is abundantly ready to impose not only its generally narrow views of its interests but its abstract opinions, and even its tastes, as laws binding upon individuals."

* * * *

"A third general objection to government agency rests on the principle of the division of labor. Every additional function undertaken by the government is a fresh occupation imposed upon a body already overcharged with duties. A natural consequence is that most things are ill done; much not done at all, because the government is not able to do it without delays which are fatal to its purpose; that the more troublesome, and less showy, of the functions undertaken are postponed or neglected, and an excuse is always ready for the neglect; while the heads of the administration have their minds so fully taken up with official details, in however perfunctory a manner superintended, that they have no time or thought to spare for the great interests of the state, and the preparation of enlarged measures of social improvement.

"But these inconveniences, though real and serious, result much more from the bad organization of governments than from the extent and variety of the duties undertaken by them. Government is not a name for some one functionary, or definite number of functionaries; there may be almost any amount of division of labor within the administrative body itself. The evil in question is felt in great magnitude under some of the governments of the Continent, where six or eight men, living at the capital

and known by the name of ministers, demand that the whole public business of the country shall pass, or be supposed to pass, under their individual eye. But the inconvenience would be reduced to a very manageable compass in a country in which there was a proper distribution of functions between the central and local officers of government, and in which the central body was divided into a sufficient number of departments."

* * * *

"But though a better organization of governments would greatly diminish the force of the objection to the mere multiplication of their duties, it would still remain true that in all the more advanced communities the great majority of things are worse done by the intervention of government than the individuals most interested in the matter would do them, or cause them to be done, if left to themselves. The grounds of this truth are expressed with tolerable exactness in the popular dictum, that people understand their own business and their own interests better, and care for them more, than the government does, or can be expected to do. This maxim holds true throughout the greatest part of the business of life, and wherever it is true we ought to condemn every kind of government intervention that conflicts with it. The inferiority of government agency, for example, in any of the common operations of industry or commerce is proved by the fact, that it is hardly ever able to maintain itself in equal competition with individual agency, where the individuals possess the requisite degree of industrial enterprise and can command the necessary assemblage of means. All the facilities which a government enjoys of access to information; all the means which it possesses of remunerating, and therefore of commanding, the best available talent in the market—are not an equivalent for the one great disadvantage of an inferior interest in the result."

* * * *

"I have reserved for the last place one of the strongest of the reasons against the extension of government agency. Even if the government could comprehend within itself, in each department, all the most eminent intellectual capacity and active talent of the nation, it would not be the less desirable that the conduct of a large portion of the affairs of society should be left in the hands of the persons immediately interested in them. The business of life is an essential part of the practical education of a people; without which, book and school instruction, though most necessary and salutary, does not suffice to qualify them for conduct, and for the adaptation of means to ends. Instruction is only one of the desiderata of mental improvement; another, almost as indispensable, is a vigorous exercise of the active energies: labor, contrivance, judgment, self-control; and the natural stimulus to these is the difficulties of life. This doctrine is not to be confounded with the complacent optimism, which represents the evils of life as desirable things, because they call forth qualities adapted to combat with evils. It is only because the difficulties exist, that the qualities which combat with them are of any value. As practical beings it is our business to free human life from as many as possible of its difficulties, and not to keep up a stock of them as hunters preserve game for the exercise of pursuing it. But since the

need of active talent and practical judgment in the affairs of life can only be diminished, and not, even on the most favorable supposition, done away with, it is important that those endowments should be cultivated not merely in a select few, but in all, and that the cultivation should be more varied and complete than most persons are able to find in the narrow sphere of their merely individual interests. A people among whom there is no habit of spontaneous action for a collective interest—who look habitually to their government to command or prompt them in all matters of joint concern—who expect to have everything done for them, except what can be made an affair of mere habit and routine—have their faculties only half developed; their education is defective in one of its most important branches.

"Not only is the cultivation of the active faculties by exercise diffused through the whole community, in itself one of the most valuable of national possessions: it is rendered, not less, but more, necessary, when a high degree of that indispensable culture is systematically kept up in the chiefs and functionaries of the state. There cannot be a combination of circumstances more dangerous to human welfare than that in which intelligence and talent are maintained at a high standard within a governing corporation, but starved and discouraged outside the pale. Such a system, more completely than any other, embodies the idea of despotism, by arming with intellectual superiority as an additional weapon those who have already the legal power. It approaches as nearly as the organic difference between human beings and other animals admits to the government of sheep by their shepherd, without anything like so strong an interest as the shepherd has in the thriving condition of the flock. The only security against political slavery is the check maintained over governors by the diffusion of intelligence, activity, and public spirit among the governed. Experience proves the extreme difficulty of permanently keeping up a sufficiently high standard of those qualities: a difficulty which increases, as the advance of civilization and security removes one after another of the hardships, embarrassments, and dangers against which individuals had formerly no resource but in their own strength, skill, and courage. It is therefore of supreme importance that all classes of the community, down to the lowest, should have much to do for themselves; that as great a demand should be made upon their intelligence and virtue as it is in any respect equal to; that the government should not only leave as far as possible to their own faculties the conduct of whatever concerns themselves alone, but should suffer them, or rather encourage them, to manage as many as possible of their joint concerns by voluntary cooperation: since this discussion and management of collective interests is the great school of that public spirit, and the great source of that intelligence of public affairs, which are always regarded as the distinctive character of the public of free countries."

Mill conceded, however, that, while the presumption should always be in favor of liberty, there were numerous cases in which governmental interference could be justified. These, briefly, are cases in which the persons concerned do not understand their own interest, as

education; or are exercising power over other persons, such as infants, or idiots, who "are everywhere regarded as proper objects of the care of the state"; or can manage their affairs only through agents, as the shareholders of a joint-stock company, which needs proper regulation; or cannot give practical effect to their desires unless a common rule is imposed upon all concerned, as laborers who wish to shorten their hours of toil; or who are aided by the government in the general interest of society, as paupers; or are conducting literary or scientific undertakings which do not appeal to the interest of enough private individuals to secure the needful support. Mill then concludes:

"The preceding heads comprise, to the best of my judgment, the whole of the exceptions to the practical maxim, that the business of society can be best performed by private and voluntary agency. It is, however, necessary to add, that the intervention of government cannot always practically stop short at the limit which defines the cases intrinsically suitable for it. In the particular circumstances of a given age or nation there is scarcely anything, really important to the general interest, which it may not be desirable, or even necessary, that the government should take upon itself, not because private individuals cannot effectually perform it, but because they will not. At some times and places there will be no roads, docks, harbors, canals, works of irrigation, hospitals, schools, colleges, printing presses, unless the government establishes them; the public being either too poor to command the necessary resources, or too little advanced in intelligence to appreciate the ends, or not sufficiently practiced in joint action to be capable of the means. This is true, more or less, of all countries inured to despotism, and particularly of those in which there is a very wide distance in civilization between the people and the government: as in those which have been conquered and are retained in subjection by a more energetic and more cultivated people. In many parts of the world the people can do nothing for themselves which requires large means and combined action; all such things are left undone unless done by the state. In these cases the mode in which the government can most surely demonstrate the sincerity with which it intends the greatest good of its subjects is by doing the things which are made incumbent on it by the helplessness of the public, in such a manner as shall tend not to increase and perpetuate but to correct that helplessness. A good government will give all its aid in such a shape as to encourage and nurture any rudiments it may find of a spirit of individual exertion."

* * * *

"I have not thought it necessary here to insist on that part of the functions of government which all admit to be indispensable, the function of prohibiting and punishing such conduct on the part of individuals in the exercise of their freedom as is clearly injurious to other persons, whether the case be one of force, fraud, or negligence. Even in the best state which society has yet reached, it is lamentable to think how great a proportion of all the efforts and talents in the world are employed in merely neutralizing one another. It is the proper end of government to reduce this wretched

waste to the smallest possible amount, by taking such measures as shall cause the energies now spent by mankind in injuring one another, or in protecting themselves against injury, to be turned to the legitimate employment of the human faculties, that of compelling the powers of nature to be more and more subservient to physical and moral good."

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BARBARA WOOTTON

Freedom Under Planning

IN SHARP contrast to the views expressed in the previous selection, Barbara Wootton would place the state in the center of a planned economy. In the book * from which the following selection is taken, she wrestles with the problem of maintaining certain freedoms in the type of society she anticipates and would welcome. In the introductory chapter she deals with the concepts of freedom and planning and sets the stage for her later analysis in which she argues that cultural freedom and civil rights are compatible with planning and that freedom to choose consumption goods and alternative vocations need be curtailed very little. On the other hand, the pattern of production would be controlled and this would require much control of prices (including wages).

Introduction

I

The Freedoms that matter in ordinary life are definite and concrete; and they change with the changing ways of different ages and different civilizations. Freedom today might mean, for instance, freedom to ask for your cards and sweep out of an objectionable job; freedom to say what you think of the government in language of your own choosing; freedom to join, or to refuse to join, the Transport and General Workers' Union; freedom to start a rival Union on your own; freedom to be a Freemason, a Catholic or a Plymouth Brother; freedom from concentration camps, official spying and deten-

* Reprinted from *Freedom Under Planning,* Chap. 1, by Barbara Wootton, by permission of The University of North Carolina Press, Chapel Hill. Copyright, 1945, by The University of North Carolina Press. The author, writing in England, has drawn her illustrative material from British life.

tion without trial; freedom to stand for Parliament or the Parish Council on any program that you like; freedom to strike or not to strike; freedom to wear a nightdress or pyjamas as you prefer. No one would suggest that all these freedoms are of equal importance; nor do these examples necessarily cover all the freedoms that we actually have, can have, or ought to have. The relative value of different freedoms, and the conditions under which they can in fact be realized are difficult and debatable matters, and are, in fact, debated in the pages that follow. But a random list of typical contemporary freedoms is useful as a reminder that free*dom* has to be perpetually reinterpreted into free*doms*. You can philosophize endlessly about freedom; but in daily life it is freedoms that you want. This book would in fact have been called *Freedoms Under Planning,* had not the title been so impossibly ugly.

At the same time all freedoms have a common quality—the quality, in fact, of freedom. If the discussion is to be practical and realistic, it is necessary to have a working notion of what this particular quality is. For the purpose of this book, which is severely practical, freedom may be simply defined as ability to do what you want. Behind every word in that definition there lurks, admittedly, a mass of philosophic doubts and subtleties. In practice one must turn a blind eye to these, and build on the assumption that in ordinary life most people recognize the difference between ability to do what they want, and inability to do this. Lack of freedom, at all events, is unmistakable enough. Most of us know only too well the peculiar emotion of frustration by which denial or deprivation of freedom is accompanied.

Taking this earthy, commonsense view of the nature of freedom, we admittedly bypass the complex issues raised by the child who, on returning to a progressive school after the holidays, is said to have asked: "Mummy, shall I still have to do what I want to do?" Equally we suspend judgment on the implications of the (no doubt apocryphal) Treasury Minute[1] which declared that: "It is one thing to compel an officer to retire voluntarily, another to permit him to retire compulsorily. Please keep the two distinct, lest worse confusion befall." What is more important, we deny the validity, for all practical purposes, of any distinction between what people want to do, and what they "really" want to do. Any such distinction is extremely dangerous, and may be the cloak for some of the most wicked, because the most insidious, attacks upon freedom. For sooner or later what I "really" want to do turns out to be a polite paraphrase for what you think I ought to want to do. But freedom means freedom to do what *I* want, and not what anybody else wants me to want—or else it has no meaning at all. How my wants come to be what they are is, no doubt, the result of a complex social and personal process which had best be left to the psychologist to explore. So far as freedom is concerned, what people want to do must be taken as something to be discovered, not changed.

There is another reason for emphasizing this. Freedom for everybody to do what he wants is not necessarily the sole purpose of organized

[1] Quoted by Mallalieu: *Pass to you, Please,* p. 105.

society. There may be other admirable social ends which conflict with, or demand, limitations upon freedom. The possibility of one such conflict and the methods by which it may be resolved is indeed the theme of this book. It is, however, possible to use the word freedom in such a comprehensive way that it covers practically every conceivable social end. For instance, a full belly and an educated mind are commonly thought of today as good things in themselves; and the view is widely held that it is the business of the state to see that people are in fact in a position to enjoy these blessings. But the use of the terms "freedom from want" and "freedom from ignorance" to describe these desirable conditions is liable to confuse any serious discussion of freedom, and to obscure real problems. For in this way the term freedom is easily stretched so wide as to be emptied of distinctive meaning; and the very possibility of conflict, real enough in experience, between freedom and other praiseworthy social ends is disposed of by a verbal trick. The fact is, of course, that people's freedom—their ability to do what they want—is affected in many and complex ways by nearly every kind of organized social activity. Thus, one of the reasons for desiring a full stomach is that, if your stomach is empty, you will not be free to do anything else until you have filled it. But it is absurd to infer from this either that freedom consists in, and is identical with, a state of repletion, or that the limitation which the pangs of hunger impose on your freedom is the only reason for wishing to be rid of those pangs. A condition of well-fed, well-housed, well-clad, even well-entertained, slavery is not an imaginary impossibility. It is only too possible. But it is not freedom. Freedom should not be defined in terms which, even by implication, deny the possibility that a high degree of material well-being may be accompanied by deprivation of freedom. Prisoners would not become free men if they were looked after as well as race horses.

Where all the terms are so highly charged with political bias it is necessary to be unusually careful about definitions. What then is meant by planning? Planning, in the sense that is relevant here, may be defined as the conscious and deliberate choice of economic priorities by some public authority. Economic activity consists essentially of choice. Shall I spend this shilling on a pint of mild or send a greetings telegram to my mother on her birthday? Shall I buy a house or rent one? Shall this field be plowed, left as pasture or built over? The first two of these choices may be said to be concerned with priorities of consumption, the third with priorities of production. There must of course always be some connection between the two kinds of choice, since it is not possible to consume that which is not produced. In the long run the pattern of consumption, apart from saving and waste (both of which, by a stretch of language not greater than is customary in the peculiar vocabulary of economics, may be included as special forms of consumption) is identical with the pattern of production. It does not, however, follow that whoever determines the general pattern of production also necessarily decides just exactly what each individual will consume.

It is this planning of production which is the heart of the matter.

Since it is not possible to produce indefinite quantities of everything in a given place, as for instance in this island, there must be choice, and there must be priority. You cannot feed a cow off a suburban villa; to that extent there is on every acre a conflict between agriculture and building, in which one must eventually give way to the other. In every case, therefore, priorities of production must somehow be eventually determined. In the world as we know it there are, in principle, two ways, in one or other or both of which these questions can be settled. They can be settled consciously and deliberately as part of a plan, or they can be left to settle themselves through the higgling of the market (more politely known as the market mechanism). In the latter case, the final picture emerges as the unpremeditated result of the decisions of perhaps thousands of people, each of whom is concerned only with his own particular part (and that often a very tiny one) of the whole. Planning, on the other hand, implies that there is a known target to be aimed at. In the Soviet Union, the planned output of coal, for instance, in the third year of the second five-year plan, was 110 million tons. The output actually realized was 108.9 million tons.[2] The plan figure thus stands as a measure by which to judge the results that were in fact recorded. In this country, at about the same time, the annual output of coal was 226.5 million tons. Nobody planned that. It happened.

It will be noticed that I have confined the term planning to the determination of priorities by a public authority. In this context "public authority" means a state or government (with police and military power to give effect to its decisions if necessary); or some other body which the state has itself created, or to which it has expressly devolved certain rights and duties—such as the London County Council, created by Act of Parliament in 1888, or the London Passenger Transport Board, also created by Act of Parliament, in 1933. This limitation on the meaning of planning is a matter of convenience. In ordinary speech the decision to put a shilling on a horse may well be spoken of as part of an *individual's* economic plan; and in some instances large-scale economic planning may be undertaken by other than public bodies. The total output of certain chemicals in this country, for instance, must be fairly closely planned by Imperial Chemical Industries. The policy of that firm will make a most significant difference to the total. As has been said, however, the uncoordinated small-scale plans of individuals generally add up to a result which is completely unplanned; and the large-scale planning of private monopolies raises issues which, though alarming and important enough, are different from those characteristic of what is coming to be called a "planned economic system."

The use of the phrase "economic system" must not be held to imply that the world is neatly divided into planned economies on the one hand, and unplanned economies on the other. Planning is a matter of degree. It is nowhere completely absent nor does it anywhere cover 100 per cent of all economic activity. Yet the span that divides the Soviet Union from New Deal America may be wide

[2] State Planning Commission of the U.S.S.R., *The Second Five-Year Plan*, p. xxiv.

enough to justify the use, as a convenient shorthand, of the respective labels "planned" and "unplanned" "*system*." Even in the Soviet Union, the collective farmer can grow and sell what he likes as he likes on his own modest allotment, not bothering about anybody's plans but his own. In real life a pure economy is as improbable as a pure race. Economic hybrids are scarcely less varied than biological.

If, for practical purposes, economic planning is to mean *state* economic planning, it follows that, in the present stage of political development, plans must be confined within national boundaries. M. Stalin's government can make and execute most comprehensive plans of production throughout the vast areas over which they rule. If they wish to extend the geographical scope of their plans, they must first find some way of incorporating the territory of their neighbors into the Soviet Union. International economic planning is indeed possible in the sense that independent governments may agree to co-operate in certain economic activities, or create joint organs to regulate the output of particular commodities. The production of rubber and other raw materials was internationally planned in this way before the war. The status of plans of this kind is, however, necessarily quite different from that of those imposed by a government within the limits of its own authority. If the members of the Blankshire County Council fail to carry out their statutory duty to provide education for the children of the county in accordance with plans laid down by Parliament, they will personally be compelled by force of law to conform, or to get out: and it will be no use pleading that the people of Blankshire, holding as they do that ignorance is bliss, do not therefore wish to be bothered with education. But if the Dutch government took a dislike to the rubber control scheme and decided to disregard its provisions, they would have been amenable to no effective authority. The Dutch electors might refuse at their next opportunity to re-elect a government that had proved so careless of its bond. But that would still be a matter only between Dutch and Dutch. The remaining parties to the agreement, outside Holland, must confine themselves to protests, or in the last resort to economic or military sanctions directed, not against the offending members of the Netherlands government, but against the Dutch people as a whole. If the Blankshire County Council ignores the law, there is no question of blockading or bombing the County.

This difference between the activities of governments inside and outside their own boundaries is as plain as a pikestaff as well as quite fundamental. But it is sometimes forgotten in practice. The members of an international planning authority (the phrase, in a world of still sovereign states, is actually a contradiction in terms) are either severally responsible to the several governments by whom they have been appointed (each one of which may at any time change its mind about the whole business); or else they are responsible to no one—self-appointed dictators in fact. Incidentally, this dilemma necessarily tempers, though it does not invalidate, the hope that international political unity will eventually emerge from, rather than precede, international economic integration. For present purposes its chief significance

is that it unavoidably limits the scope of the discussion. A plan which has the force of law is at most, as things are, a national plan. A planned economy can only mean an economy which is predominantly planned by the government of one state (or its appointees) for the people of that state. This of itself creates certain special problems affecting freedom, different from those which would be raised by the world-wide plans of a government of world-wide authority.

It is perhaps worth adding that state planning or priorities in production, even if it covered much the greater part of our economic life, is not necessarily identical with socialism. Socialism is generally held to mean (among other things) public ownership and operation of industry. Now, in theory at least, it is quite possible for the state to make all major decisions about how much of what is to be produced, without itself undertaking anything approaching the whole of that production. That is indeed, near enough, what happens in war. Production and priorities are officially planned and are carried out to government order; but by no means all these orders are executed in firms in which the workers are directly government employees. In principle, therefore, the distinction between socialism and economic planning is parallel with the distinction between doing something yourself and telling, or paying, somebody else to do it. How far such planning without socialism would be practicable except in the special circumstances of war is a question to which experience gives as yet no clear answer. The convinced socialist (if he can be persuaded to proceed beyond dogmatic assertion that the two are inherently incompatible) will argue that government plans which are not also government-executed will either founder on the rocks of vested interest, or be wrecked by exploitation. In a world where business men are accustomed to make their own plans with an eye on their own or their firm's profit, very strong pressure may be put on the government to frame its own programs to suit the wishes at least of those private concerns which are large enough to make themselves heard. If this fails, the business world, it is said, will bring up a large armory of weapons with which to defeat the substance, while accepting the letter, of a government program; and finally the apparatus of controls (price regulation, profit limitation, quotas, perhaps concentration of industry, to name only a few complexities) which government will need to establish to prevent such tricks—will prove so formidable that in the end the conclusion that it would be more sensible to do the job yourself will become irresistible. That is, anyhow, how it looks to the socialist. What people will put up with in the war, he will say, is no guide to what can be done with them in peace; and, even in war, it cannot be said that the enforcement of the controls necessary for comprehensive planning is either frictionless or easy. The amount of effort which is devoted to circumventing government regulations seems to be considerable: the amount of effort devoted to circumventing such efforts to circumvent the law is even greater. And even so there are still black markets and prosecutions. If this is what happens in war, the socialist will write off the possibilities of public planning without public production in peacetime,

when the danger and the glory are past, as hopeless. Necessarily, however, this remains a question of opinion. Nor is it certain that the answer is the same for all communities at all times. Business men vary both in their predatory qualities, and in their sense of public responsibility. Until the weight of experience is conclusive one way or the other, the problems of freedom under planning must be treated as distinct from those of freedom under socialism. But the prudent will remember the possibility that the one may lead to the other.

II

I have said that it is freedoms, rather than freedom, which matters. It may clear the ground a little further if these freedoms are roughly classified. We may distinguish civil, cultural, political and economic freedoms. The civil and cultural are much the most difficult to define with precision. Cultural liberty includes many varied freedoms of action and expression, while civil freedoms cover chiefly various legal, or judicial, rights which are particularly important to persons rightly or wrongly accused of offenses against the law. Among the former free speech and religious freedom are generally ranked high: among the latter we count in this country *habeas corpus,* and the right to trial by a tribunal which is not also a party to the prosecution. Political freedoms are those which have to do with the right to choose, to change, or to influence, the government in power. Freedom to vote or to form an opposition political party are two practical examples. Economic freedoms are those primarily concerned with getting and spending an income, or with the use and ownership of property. It is obvious that this classification is not watertight. Freedom of speech, for example, if one wishes to speak on political topics, overlaps the boundary between civil and political freedoms. Freedom to join a Trade Union is often ranked as one form of the civil freedom of association; but its intention and purpose are plainly economic. Watertight compartments, however, are the rule in ships, not in social affairs, where indeed they are quite exceptional. These leakages do not destroy the usefulness of classification; for merely to make such a classification brings out the fact that the effect of public economic planning upon, say, the freedom to ask for your cards and sweep out, is likely to be, at the least, more direct than its impact upon freedom from imprisonment without trial.

* * * *

In the background of this controversy there lies one further distinction which is quite fundamental. That is the distinction between those effects on freedom which are inherent in any kind of plan, and those which are related to the content of a particular plan, or to the particular method of its operation. If Miss Jaeger is right and *any* plan is incompatible with the chief economic, political and civil freedoms, then the problems concerned with the differences between one plan and another are not worth discussing. We are sunk anyway. If, on the other hand the mere technique of planning is not necessarily destructive of these freedoms, it certainly does not follow that all the problems of freedom under planning are settled. To show, for instance, that the government can effectively determine economic

priorities without recourse to compulsory direction of labor is not the same as to show that any actual economic plan will be either wise or popular or conducive to freedom. To show that planners need not exercise certain powers is not the same as to show that they will not. To show that it is possible to plan for good is not the same as to show that it is impossible to plan for evil.

To simplify the discussion, these two sets of problems are treated separately in the pages that follow. The first nine chapters of this book are concerned with those effects on freedom which may result from the fact of planning: to keep the issue clear, it is assumed throughout these chapters that the planners are public-spirited people who seek only to discover the common good, and to do their best for it. In the final chapter this assumption is challenged. Where and how, we then ask, can we find safeguards that the men and women who have the power to choose will in practice plan for, and not against, the freedom of those in whose name this power is exercised? Astonishingly little attention has been given to this second group of problems—and that in the age of Hitler, Mussolini, Mustapha Kemal and Stalin. The thinkers of the Right, satisfied with their demonstration of the inherent incompatibility of planning and freedom, can legitimately pass these problems by; but the common assumption of the Left that disproof of the inevitability of this contradiction is enough to establish the case for planning is too facile. "The essence of Democracy" says *Commonwealth,* "is that the resources of the State are a common possession to be managed on behalf of all, by the representatives of all, *for the benefit of all.*"[3] Before this essence can be distilled into concrete social and political institutions, however, a number of conditions must be fulfilled. The justification of planning, in terms of freedom, must be that by conscious collective decision of economic priorities our frustrations are diminished and our freedoms enlarged: that we have more opportunity to do what we want to do. This in turn implies (1) that objectives exist which can properly be described as "for the benefit of all," (2) that these objectives can be ascertained with reasonable accuracy, and (3) that the men and women on whom lies the duty of making decisions "for the benefit of all and on behalf of all" will in fact continuously pursue these objectives.

* * * * *

Granted that some common needs exist and that these can be, if not known, at least the subject of better or worse guesses, freedom still demands assurance that it is for these needs and no others that the planners shall in fact plan. This is probably the most tricky part of the whole business; for the observed behavior of human beings in positions of power hardly justifies an easy assumption that they will automatically act, according to the best of their ability and understanding, "on behalf of all and for the benefit of all." The fact that this assumption is so generally, and so light-heartedly, made by those who are convinced of the beneficial potentialities of planning is no doubt a tribute to the good hearts of those who make it. They generously ascribe to others their own good intentions, picturing all planners as men and women as

[3] *Commonwealth.* Five-Point Program, p. 9. Italics mine.

zealous and public-spirited as they are themselves. It is a generous optimism: but the prudent will not forget the fact that planning is not possible without power, and that power, whether in the hands of prime minister or railway guard, is potential tyranny. A wise choice of planners and a watchful eye on plans may well be the price of freedom.

None of these three conditions, as I hope to suggest in the pages that follow, is incapable of fulfillment. But they will not fulfill themselves.

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GEORGE SOULE

The Need For Planning

THE need for coordination is a driving force behind the expanding role of the state. This need is propounded in the following passage from George Soule * by means of a neat analogy.

In one important respect, however, the analogy between the business order and the human body is a most imperfect one. This very imperfection gives a clue to the solution we are seeking. The human body is a high type of organism, with a natural equilibrium in its processes. But the business order is scarcely an organism at all; at best it is a low type of organism, a complex characterized in large degree by disorder and lack of balance. Its action is anarchistically determined by the choices of hundreds of thousands of theoretically independent cells. Each person or business concern decides how much to spend and how much to save. Each decides what to buy and what to do with the savings. Production, investment, credit, prices, wage payments and all the rest are the result of countless choices in countless places. Each choice is, to be sure, largely determined by the conditions produced by all the other choices, but few of them are made on the basis of adequate information and foresight, and almost none of them depends on a plan or policy related to the common interest. If we are to think of the business order as a body, we must think of it as a body without a brain. We have magnificent muscles in our great industrial plants, efficient arteries in our railroads and highways, sensitive nerves in our lines of communication. But we have only a trace of gray matter in our economic cranium. If our economic leg muscles

* From *A Planned Society* (New York: The Macmillan Company, 1932), pp. 59–60. By permission of The Macmillan Company, publishers.

decide to run after a butterfly and our arm muscles are intent on picking wild flowers at the very time when our stomach is crying for bread and butter, we ought not be surprised by the resulting hunger. We should not be so surprised if we had a brain.

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S. PARKER GILBERT

The Conservative View of Federal Expenditures and Planning

THE reactions of the "old-school" American businessman to the expansion of government and taxation that occurred during the thirties are indicated in the following selection: *

The progress thus far made in balancing the cash budget must not be allowed to obscure the vital importance of more effective control and further curtailment of expenditures. Even now, on the basis of the Treasury's latest estimates, the Federal Government will be spending this fiscal year at the rate of around seven billion dollars. This is far too heavy a burden for the people to bear. It is gradually lowering the general standard of living, and as the Government takes to itself in taxes more and more of the country's annual production, less and less, whether they realize it or not, is left for the people as a whole. The first principle, therefore, is that no additional taxation should be levied, and that further progress should be made by curtailing expenditures rather than by new taxes. The opportunities for curtailment have barely been touched. The task which remains can be accomplished, but it requires in the first place constant Executive pressure through the Treasury and the Bureau of the Budget to bring down to reasonable figures the expenditures of the Executive Departments and the spending agencies. It requires a willingness in Washington, and a determination in the states and municipalities, to return to our best traditions of local self-government and local self-reliance. It requires self-denial on the part of those vested interests in spending which have grown so great in recent

* Reprinted by permission from "Expenditures of the Federal Government," *Proceedings of the Academy of Political Science*, XVII, No. 4 (Jan. 1938), published by the Academy of Political Science, Columbia University, New York City, 105–113.

years. Above all, it requires the active interest and support of the great body of the people for the efforts which the Treasury and the Executive make in the direction of real economy. There are still vastly more taxpayers, direct and indirect, than there are beneficiaries of Government payments; and if the taxpayers will only assert themselves, the Treasury's pressure to reduce expenditures will be immeasurably more effective.

The national credit depends not merely on the control of expenditures, but also on the taxing power and the state of the revenues. Here the outstanding fact is that the country is already too heavily taxed, that present taxes are sapping its vitality and impairing the sources of revenue. Taxes should in fact be reduced. And a wise revision of the laws, which moderated the present extremes and showed regard for the trend of the country's business, would by revitalizing agriculture, industry and employment put the revenues on a much healthier basis and yield at least as good returns. At present it is fair to say that we have probably the worst tax system of any civilized country. This is not the fault so much of any one political party or administration, though it must be admitted that the last five revenue laws, passed one each year for five years, have contributed some of the worst pieces to the crazy quilt.

Our present taxes are oppressive and destructive, and in combination with the complicated and frequently very high taxes imposed by states and municipalities on the same taxpayers, often come close to the point of confiscation. Instead of aiming to collect fair taxes on the multitudes of transactions and the great volume of business profits which would normally occur in a great country like ours, the tax laws prevent transactions and dry up business profits and business initiative. They have greatly impaired both individual and corporate savings, so that there no longer exists an adequate fund of savings to finance improvements and new enterprise. Frequently, they aim largely to punish, or to accomplish other ulterior objectives, but whatever satisfaction this may give, we are learning that it does not produce revenue.

* * * *

For the time being there is no doubt that we are experiencing a business recession of unusual suddenness and some magnitude. It lies largely in the hands of the political authorities, and the public opinion of the country as expressed through them, to determine whether it shall develop into a severe depression or terminate in a new and sounder recovery. Many factors are favorable. The dollar, for example, is not now overvalued and is not vulnerable, as it was in the last depression, to great foreign withdrawals. This year we have had the best crops for many years, and these, it seems to me, are still to be regarded as a blessing and not as a "national calamity." Generally speaking, the material for recovery exists.

On the other hand business is still struggling under many handicaps and uncertainties which it is within the power of the Government to relieve. Apart from those which we have already discussed, there are still deadlocks in the great building and public utility industries, due mainly to Government competition, interference and hostility. These are

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productivity of the tax goes to increase of savings and thus expands the fund from which the taxes of the future are to be drawn. On the sixth hypothesis the surplus government revenue is most efficiently employed in such outlay, for example, as scientific research or agricultural experiment so that the individual income increases much in excess of the tax. This surplus economic energy made possible by efficient public cooperation would result both in a higher standard of living and an increase in the total capital goods. The seventh hypothesis is identical with the sixth except in the assumption that the second one hundred dollars of revenue in the sixth were derived from a general property or income tax, and the equivalent revenue of the seventh was derived from an excise tax on specific articles of consumption which injure the health, strength, or happiness of the consumer. Such a sumptuary tax would not alter the welfare that is susceptible to pecuniary valuation. The public revenue, the capital accumulation, and the individual consumption in terms of money would be the same. But the restriction of unwise consumption would leave a larger fund for the purchase of beneficial goods and services. There would be an increased consumption of wealth and a decreased consumption of "illth" to the end of an enhancement of the general well-being. The assumption in all of these hypothetical cases is that the effort required in earning the income is the same.

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THE TAX INSTITUTE

The Cost of War

ONE of the previous selections suggested that war is a major cause of rising public expenditures. More evidence concerning this proposition follows: *

The cost of war is not measured in dollars and cents but in human suffering the depths of which are beyond measurement. The burden of this suffering is as irregular as it is immeasurable. Not even death comes alike to all men.

It is only the financial cost of war which we can essay to measure, and then only in crude approximations. Who shall assess the value of the peasant's small belongings or the art treasures of the world that are swept away in the dreadful holocaust? Let

* *Tax Policy*, XI, No. 5 (March 1944) (adapted). Reprinted by permission of the Tax Institute, New York.

us be painfully aware of these larger areas of cost when we begin to estimate the expenditures of governments for the waging of war.

Less than a decade ago a few persons here and there were vaguely aware that the next war would be expensive, but their ideas of expense seem limited from the standpoint of present actualities. "NEXT WAR TO COST NATION 10 BILLION A YEAR, HEAD OF ARMY PLANNING BOARD DECLARES," was the headline of a rather inconspicuous article in *The New York Times* on February 12, 1936. The speaker made the further daring assertion that "If it is necessary to cut the cuff off a man's trousers to have materials, we'll do so."

The Cost of Earlier Wars

Wars have always been costly affairs in terms of the current economy. Nothing comparable in monetary outlay to the present war has ever been known, however. In some primitive tribes the manpower of the tribe was devoted largely to making war while women carried on the economic pursuits. For such peoples, however, the making of war was largely a form of economic enterprise because of booty taken from conquered tribes. The militaristic countries of the current century have disregarded the impoverishing effect of modern wars for both victor and vanquished, and apparently represent a psychological throwback to the idea of war as a method of national enrichment.

At the outset of the First World War, Germany "had so confidently counted upon victory with resultant huge indemnities, that it resolved to follow the loan policy, at all events so far as the imperial government was concerned."[1] There seems little doubt that Japan, Italy, and Nazi Germany likewise expected their respective Manchukuoan, Ethiopian, and European adventures to be profitable.

The costs of the Napoleonic Wars have been estimated at $10 to $15 billion, of which England spent about $3.5 billion.[2]

Professor E. R. A. Seligman has estimated that the costs of the First World War amounted to more than $210 billion.[3]

"The figures, it must be remembered, cover the cost of the war up to a period from six to twelve months after the conclusion of hostilities. In many countries, however, large expenses directly connected with the winding up of the war continued, and in any final statement the prodigious figures of the cost of reconstruction and reparation would have to be added. These will without much doubt ultimately well-nigh double the above estimate."[4]

The Costs of United States Wars

It has been estimated by the National Industrial Conference Board that the United States spent almost 53 billion dollars in wars from 1775–1921. The following table is reproduced from *Tax Burdens and Public Expenditures* published by the Board in 1925.

The increasing costliness in monetary terms of waging war is clearly illustrated by this table. The Revolutionary War lasted eight years and

[1] E. R. A. Seligman, *Essays in Taxation,* p. 761.
[2] L. V. Birck, *The Public Debt,* p. 203.
[3] Seligman, *op. cit.,* p. 755.
[4] *Ibid.*

cost the country half a billion dollars. The Civil War lasted four years and cost fourteen billion dollars. The

The Costs of American Wars, 1775–1921

Revolution	$ 504,288,328
War of 1812	309,605,729
Mexican War	497,916,983
Civil War—Union	12,322,186,601
Civil War—Confederacy	1,520,033,632
Indian Wars	800,000,000
Spanish-American War	3,521,776,681
World War	33,131,986,757
Total	$52,607,776,711

United States was in the first World War less than two years and spent thirty-three billion on it. To bring the record up to date it has been engaged in the second World War a little over three years and has spent almost two hundred billion dollars to date. In other words, the average annual cost of waging war was about one-sixteenth of a billion dollars during the Revolutionary War, about three and a half billion during the Civil War, about seventeen billion during the first World War, and over fifty billion during this war.

Prewar Costs

It has been estimated that something like $62 billion was spent in preparations for war from 1930 until the end of 1938. "The price of the world's precarious peace today is somewhere in the neighborhood of fourteen to fifteen billion dollars per annum—six times the amount paid in the year before the World War. This vast sum is being spent in 1938 on the world's armies, navies and air forces. . . . Nowhere is the unhappy state of the world so accurately reflected as in the national budgets and in the armories of Mars—the arsenals, munitions plants, shipyards and plane factories. The armories thrive, but in the ledgers of today are entered promissory notes against tomorrow, and debit columns of red ink march down the pages of history." [5]

During the early and middle thirties while idealists of other countries were fondly dreaming of no more wars, or at least of "peace in our time," Hitlerite Germany was busily preparing for war.

"Looking first at the German experience, we find an outstanding example of a nation which started its vast rearmament program at the bottom of a great depression when profits and wages were very low and unemployment was widespread, and had six and one-half years in which to work out a carefully organized and coordinated plan of expansion while the rest of the world slept. Germany, according to Hitler, spent in that period over 90 billion marks on armaments." [6]

The Cost of World War II

We do not know how long the present war will last. At the moment there appears to be a great deal of fighting ahead. There has been a steadily rising crescendo of war activity on ever-wider battlefields since the 1939–40 days of what armchair strategists were pleased to call the "phony war." Events will probably move more rapidly from now on, but the attack on German and Japanese home territory still has to be made. There seems no valid reason to think, therefore, that the war is nearly won.

[5] Hanson W. Baldwin, *The New York Times*, January 23 and August 21, 1938.

[6] Crum, W. L., Fennelly, J. F., and Seltzer, L. H., *Fiscal Planning for Total War*, pp. 16–17.

German Military Outlays, 1929–1940[7]
(In billions of Reichsmarks)

Fiscal Year Beginning April 1	National Income	Military Outlays	Governmental Revenues	Ratio of Military Outlays to National Income
1929	75.9	.7	9.0 (1928)	1 per cent
1933	46.6	3.0	6.8	6
1934	52.7	6.0	8.2	11
1935	58.4	10.0	9.7	17
1936	63.1	11.0	11.5	17
1937	71.0	16.0	14.0	23
1938	79.0	25.0	17.7	32
1939	88.0	45.0	23.6	51
1940	100.0	49.0	34.0	49

By the end of 1944 the monetary cost of the war to belligerent governments will probably be close to nine hundred billion dollars and will undoubtedly reach a trillion dollars in 1945.

[7] *Op. cit.*, p. 18.

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LIFE MAGAZINE (EDITORIAL)

The Veterans

Wars are extremely expensive and, unfortunately, their expense does not end with the shooting. Nations frequently begin preparing for the next war as soon as the last one is over. Moreover, there is an aftermath of wars in public debt and outlays for veterans. The matter of veterans' demands is considered in the following selection: *

Since U.S. demobilization began, nearly 13,000,000 of the country's youngest and best men and women have been transfused back into the national life stream. If the effect of reintegration has not been quite so "atomic" as some alarmists had predicted, remember that it is only delayed action. The nation faces an unprecedented situation. We must act

decisively to make certain the effects are tonic, not toxic. We must not only rehabilitate veterans, we must also reverse America's historic veterans' policy of "too much, too late . . . to the wrong persons."

The Pattern

For the moment, veterans are preoccupied with personal problems. They are either back home with the folks or doubled up with mother-in-law while stalking a place to live. They are getting married or divorced. They are becoming parents or getting acquainted with kids left behind. They are going to school, are back at the old job, looking for a better one or trying to adjust to an economic reality that, like the pin-up girls, looked better in the pictures. Each is making that peculiar adjustment necessary when returning from the impersonal submergence of Government Issue into the individualistic catch-as-catch-can of American civilian life.

However, if history is any guide, today's veterans will make their adjustments quickly. Your veteran soon will be not only neck-deep in all sorts of politics and running with the ball in business, but will—and this is the point of our concern—follow the trail well blazed by his father, grandfather and great-grandfather in making Uncle Sam pay dearly, and long, for his wars.

It is an amazing story, this chronicle of what succeeding waves of veterans have chiseled out for themselves. Washington sent his veterans home during June 1783. There was scant money with which to pay them off; a few even tried to march on Congress for just compensation, but the majority dispersed, "the jest of tories and the scorn of whigs." In the years that followed, however, under pressure of the veterans of the Revolution and those of the War of 1812 who were eager to establish a generous precedent toward old soldiers, America began to make amends. In 1906, Esther S. Damon of Plymouth Union, Vt. passed on. She was the last widow of a veteran of the Revolutionary War, and she drew a pension to the day of her death. She had been born 33 years after the surrender of Cornwallis. In 1911, the last child of a veteran of Washington's Army died, and then, 128 years after the end of the war, the books were closed. When the total expenditure for pensions was added up it came to $70,000,000.

It may surprise some to learn that just this spring the U.S. stopped paying its last pension for the War of 1812. The recipient was Esther Ann Hill Morgan of Independence, Ore., daughter of Private John Hill of Clark's and McCumber's Companies, New York Militia. She was born 42 years after the war ended! She received $20 a month until her death. More than $46,000,000 has been paid out in the last 131 years to close the pension books on that war.

The Mexican War ended 98 years ago. The U.S. is still paying pensions to some 50 dependents of veterans of that war. In 1945 the cost was more than $31,000. Total to date: over $61,000,000.

After the Civil War, the Grand Army of the Republic teamed up with the Grand Old Party in a trade of tariffs for pensions. One result is that the Civil War has been our costliest to date in pensions, more than $8 billion. There are still 154 veterans and some 21,000 dependents on the roll, which cost almost $12,000,000 in 1945. The South was not

immune to veterans' pressures. One of the principal purposes of the original Ku-Klux-Klan was "to relieve the injured and oppressed, especially the widows and orphans of ex-Confederate soldiers." Southern States have been paying Confederate pensions out of their local treasuries for two generations.

The Indian Wars, which extended over a number of years and were not officially closed until 1898, still have 971 veterans on the pension rolls and 2,400-odd dependents of veterans. To date, they have received just short of $100,000,000, and that does not include the value of land bounties awarded the doughty Indian fighters.

The Spanish-American War ended nearly 50 years ago. Some 121,572 veterans receive pensions and so do 73,000 dependents of deceased veterans. Total expenditure to date: $2,276,470,624. In 1938 pensions were liberalized to cover all who served more than 90 days.

World War I, now 28 years in history, leaves us with 419,992 veterans drawing monthly benefits and more than 200,000 dependents of deceased veterans. Total thus far: $5,701,747,866.

These figures do not take into account money spent through the years on hospitalization, administrative and rehabilitation costs and the like. The Veterans Administration places the total benefits cost for all wars at upwards of $30 billion.

What's Coming?

It is taken for granted that such costs for World War II will dwarf all past figures. More men were mobilized than ever before, more in fact than in all previous wars combined. One out of every four World War II veterans has applied for a pension; 1,520,476 veterans' pensions have been granted at latest report, with 180,938 more for dependents. Total paid to date: $694,603,379.

The Veterans Administration budget this year is $5 billion, and it is almost certain to become the largest governmental agency. Omar B. Ketchum, legislative agent for the Veterans of Foreign Wars, has guessed that World War II pensions will run to a conservative $50 billion before they are through. The variables in such a figure not only include the apparent longevity of veterans, their fecundity and their propensity when reaching venerable years for taking child brides, but also include the future political effectiveness of veterans' organizations and whatever national economic troubles come along to spur demands.

Already there is very flabby Congressional resistance to such a measure as was debated last week, a proposal to pay enlisted veterans for earned but unused leaves, as has been done with officers. It will cost at least $2½ billion. Senator Ball (R., Minn.) had the courage to remark: "If that is the direction down which the great and powerful veterans' organizations are going to travel and take their millions of members in the next few years, then God help the United States of America."

Edith Nourse Rogers, Republican Congresswoman from Massachusetts, has introduced a bill that would provide an automobile or $1,500 cash to every veteran amputee. This is the sort of thing that touches the heart, yet cold analysis suggests there are other things amputees might need more. One of them suggested "a prosthetic appliance that would fit

and work and which would be delivered in something less than a year." It is possible that a few of the country's 16,000 World War II amputees, living in the country, or where they can park, or engaged in special trades, require a car; but by and large the Rogers proposal is a glamour item, a "kiss off."

The True Need

Veterans do not need these grab bags of poorly thought-out gratuities. They need genuine rehabilitation, to be trained and helped into good jobs and into stations in society where they do not need pensions. Except in cases of extreme disability, pensions are really confessions of failure.

All this is plain enough today. Pensions are paid according to disability, and the general philosophy of the GI Bill of Rights, which is to cost $10 to $15 billion, is toward rehabilitation. On the whole, it is working out in that direction, although apparently there are enough loopholes to define dancing schools as "educational."

What we must be on the alert for are bonus raids and loose pensioning of the historic U.S. variety. It is not too much to hope that we can turn a new leaf. For today we face an entirely new situation. Veterans should no longer be an avaricious minority in the body politic. There are too many of them. The Veterans Administration computes that 43% of the adult males of the country are now veterans or still serving. Nearly a third are veterans of World War II or still in uniform.

Citizens First

Given this situation, the need for a sharp upturn in the responsibility of veterans and their organizations is apparent. Veterans may soon be in the driver's seat, but they will also be paying for the gas and oil. The American Veterans Committee has the right slogan: "Citizens first, veterans second." That is the attitude all veterans must adopt if they are to avoid damaging from within what they fought so hard to preserve from without.

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EDUCATIONAL POLICIES COMMISSION

Education for Economic Well-Being

It is said that a nation's greatest resource is its people and that education is or can be an extremely productive investment in developing this resource. This view is expounded in the following selection: *

It is the purpose of this chapter to identify elements and characteristics of an economy which contribute to productivity, and to appraise the extent to which education contributes to them.

Economists Identify Certain Basic Factors of Production

Economists differ on details in analyzing the basic elements in the productive process. Their discussions, however, generally recognize four basic factors. Labor, whether of brain or of brawn, is identified as an essential element. Natural resources, involving the raw materials of land, water, and climate upon which production rests, constitute another basic factor. A third element in production is capital, including such factors as tools and machinery, factories, warehouses, and inventories. The efficient use of all factors of production depends upon organization and management. These have become so important in industrial economy that some class them as a fourth basic element in production.

The manner in which labor, natural resources, capital, and organization and management operate in relation to production differs in many respects in a highly specialized technological economy from that in a less advanced society. In appraising the relation of education to the foregoing factors in the productive process, we shall have in mind their roles in a highly developed industrial society such as the United States.

Intelligence and Efficiency of Labor Vitally Affect Economic Production

It is a lesson of history, as well as of contemporary times, that the human resources of a nation constitute its primary wealth. Nations have grown rich and powerful in the absence of outstanding physical resources by developing their human assets. Others have remained poor and backward in the presence of unusual natural resources. It is human intelligence which gives these resources value. To a savage, coal is black rock and a waterfall merely a physical danger to be avoided. To an

* *Education and Economic Well-Being in American Democracy* (Washington, D.C.: National Education Association, 1940), pp. 7–9; 44–46; 142–145; 205–208.

intelligent man they are the source of energy for power-driven industries of fabulous productivity.

It is such considerations which have led economists to recognize the importance of the human factor in the productive process. Seligman states the case as follows: [1]

> The older economists were fond of emphasizing the dependence of the demand for labor upon capital. While this analysis was in many respects valuable, they overlooked the independent power of labor to contribute to its own uplifting through an increase of efficiency. It is precisely here that the economic effects of education and leisure as well as of social and political progress mean so much to the community. In the commercial warfare that is being waged between nations today, education is recognized as a potent weapon. . . . The finer the tool, the greater will be the product; when the tool consists of human energy, we have not only a greater product, but a greater capacity in the human being to utilize the product.

A carefully planned and efficiently administered system of education significantly increases the intelligence and efficiency of labor. Several ways in which education exercises this important economic effect are dealt with in subsequent paragraphs.

* * * *

The Schools Should Give Greater Attention to the Education of the Consumer

The degree to which the consumption habits of a people are based on knowledge and intelligence vitally affects their economic well-being. Consumers are only beginning to recognize ways in which they can improve their knowledge and make their desires and influence effective. Consumer demand, in the final analysis, determines the character and the quality of the goods and services produced.

As purchasers go about the selection and rejection of commodities and services they dictate what shall and shall not be produced. Production schedules are determined by the economic votes cast by buyers as they spend their dollar for certain commodities and do not spend them for others. The whole direction and pattern of a democratic nations' economy are a reflection of the ideals of its consumers. If the standards held by the consumers of a nation are pitched at a low level, production schedules will be planned accordingly.

The quality of the goods produced is also largely determined by the consumer. If shoddy goods and inferior services find a ready market, they will be made available in large quantity. Understanding and intelligence on the part of the consumer, therefore, determine both the kind and quality of what is produced.[2] A study by the Twentieth Century Fund states the matter thus: [3]

> Under our present economic system the main directing source of all economic activity is expenditure by consumers. To the extent that their choices are irrational and uninformed, the system fails to reach its optimum performance.

The production of goods, sound in character and quality, is not

[1] Edwin R. A. Seligman, *Principles of Economics* (6th ed.), p. 292.

[2] Donald E. Montgomery, "How Far Can Education Solve Consumer Problems?" *Next Steps in Consumer Education* (Columbia, Mo.: Stephens College, 1939), pp. 27–41.

[3] Stewart, Paul W.; Dewhurst, J. Frederic; and Field, Louise: *Does Distribution Cost Too Much?* (New York: Twentieth Century Fund, 1939), p. 349.

enough. The intelligence of the consumer in the long run also determines whether the goods and services produced are so used that satisfaction and enjoyment are achieved. Poorly ordered purchasing may result in a loss of satisfaction which otherwise might be enjoyed. Malnutrition, for example, may result from a diet which does not include essential elements, even though the food purchased is of high quality. Well-ordered habits of purchasing and consumption, therefore, tend both to increase productive efficiency and to maximize satisfactions.

* * * *

Many Students of Superior Capacity and Diligence are Denied Educational Opportunity

The evidence is conclusive that many youths are unable to graduate from high school and attend college because of inability to meet the expenditures involved. What is the caliber of the youths eliminated? Do they possess the capacity and diligence which would permit them to qualify for occupations involving superior skill or technical knowledge and in which they could earn high incomes? The answer to this question determines whether conditions requisite to maximum productivity defined in the preceding chapter are met.

One of the early studies of this question was made by Zook in Massachusetts.[4] He tested several thousand high-school seniors and studied their scores in relation to their plans with reference to college attendance. He discovered that those planning to go on to college were in general better academic risks than those not planning to continue their formal schooling. He concluded, however, that:

> . . . there are a considerable number of pupils in the senior classes of Massachusetts high schools who are not planning to continue their education, but who nevertheless are good college material, not to speak of their fitness for other types of education. Probably in all the Massachusetts high schools there are a thousand seniors who are not planning further study who give promise of success as college students, while an additional thousand have a fair chance of success. If these two thousand students were encouraged to continue their work and were provided with courses suited to their needs and abilities, they would amply justify the money necessary to provide their education.

Many other investigations have arrived at similar findings since the foregoing study of sixteen years ago. In the Pennsylvania study by Learned and Wood over 26,000 public and private high-school seniors, tested for general intelligence, English, mathematics, history, science, and language in 1928, were followed during the next two years to discover their educational and occupational distribution. This follow-up revealed that about 25 percent of the students who were in college for at least two years after leaving high school had lower high-school test scores than over half of those who left high school to go to work. The investigators concluded that colleges are not logically selective. "Taken as a group, the high-school pupils who go to college exhibit a superior *average*, but that fact takes no account of the able and often brilliant young

[4] George F. Zook, *Report of a Fact-Finding Survey of Technical and Higher Education in Massachusetts* (Massachusetts Legislative Document, House No. 1700, December 26, 1923), p. 89.

minds that are left behind because they cannot pay college bills." [5]

Colleges in Ohio are drawing almost a "run of the mine" sampling of high-school graduates, according to Toops.[6] A statewide intelligence testing program showed half of the high-school graduates were above 40-percentile intelligence, measured by norms based on freshmen students tested in fifty or more Ohio colleges. Since Ohio has some 48,000 high-school graduates each year, this means that 24,000 of them are above college 40-percentile intelligence. This number is sufficient to fill the classrooms of Ohio's colleges twice over if all of them went to college. Few states have more higher institutions of learning than does Ohio. Yet half of its best talent does not enter college. Factors, unrelated to capacity, apparently determine which youths shall attend college and are responsible for tremendous waste in human resources of the highest caliber.

Somewhat similar findings are reported in a follow-up study of approximately one thousand pupils graduating from Texas high schools in 1937.[7] It shows that:

> . . . ability is only one of various selective factors which determine whether high school graduates will continue their education in college. Those who do enroll in college represent the whole range of ability among high-school graduates, and many who do not enroll are among those of greatest intellectual promise. Lack of finance seems to be the selective factor in keeping many of the most gifted from continuing their education.

All available investigations indicate that many youths of superior capacity are now prevented from obtaining the advanced schooling necessary to capitalize their talents. This does not mean that those who fail to complete high school and to enter college are equal as a group to those who do. Studies of the intellectual ability of high-school drop-outs as compared with those continuing in attendance show that, in general, the latter are superior. However, as a group, those who drop out because of economic necessity rank higher in ability than those leaving because of inability to succeed or because of lack of interest. It is none the less true, however, that many of those eliminated, particularly at the end of high school, have first-rate capacity. It should be remembered that more than 60 percent of youths do not graduate from high school and that only about one out of every four high-school graduates enters a college or university. Nearly 90 percent leave school before reaching the college level. Even though only a minor fraction eliminated from school have superior ability, the total number with such ability is large. This situation constitutes a major waste of our most valuable resource.

* * * *

Better Bases of Appraising Public Expenditures Are Involved

The educational program projected in this report promises in the long run to more than pay for itself through resulting increases in total national earned income. It requires, however, like any investment, that

[5] William S. Learned and Ben D. Wood, *The Student and His Knowledge* (New York: Carnegie Foundation for the Advancement of Teaching, 1938), p. 38.

[6] H. A. Toops, "Tests and Techniques." *Occupations* XII (April 1934), 20–24.

[7] Herschel T. Manuel, "Ability of High School Seniors in Relation to College Attendance," Texas Commission on Coordination of Education. *Research Bulletin* 7: 39; 1938.

money be put into it. More taxes will have to be raised if education is to be made effectively free.

It is unfortunate that this fact alone will condemn the program in the minds of certain minorities in the United States, whose attitude toward all public enterprises is dominated by uncritical opposition to increased taxation. This viewpoint is reflected by such slogans as "the less taxation the better" and "any budget can be cut."

Now, it is true that any budget can be cut. In fact, it can be eliminated altogether. The important question, however, is not whether a budget can be cut or increased, but rather, what will be the effects of cutting or increasing it.

Indiscriminate criticisms of taxation and public expenditure usually rest upon certain assumptions. It is assumed that the amount expended for a public service in itself is of great significance. Hence all increases are condemned, while all decreases are commended. This attitude in turn rests upon the assumption that money expended under public auspices is somehow swallowed up without yielding a return, while private expenditures inherently and even automatically result in tangible dividends.

These assumptions fail to recognize that proper judgment cannot be passed on public expenditures in general, or on those for particular items, except through discriminating consideration of what they buy. Governmental costs have steadily increased in the United States because an increasing population has demanded continuous expansion of public services. Public money now pays for the construction and maintenance of highways and streets swiftly traveled by nearly 30,000,000 motor cars and trucks. We pay for a vast range of services through taxation—flood control, reclamation work, river and harbor improvement, police and fire protection, sewage disposal, public health, a supply of pure water, parks and playgrounds, relief and social security, national defense, and public education in its many aspects.

Taxation and public expenditure are cooperative means of purchasing certain goods and services. Intelligent decisions concerning these services cannot rest merely on amounts spent. Is the service essential to general well-being? Is it more essential, and will it bring a greater return in worthy satisfactions and general well-being than possible alternative expenditures, whether public or private? This question must be asked again and again and answered with keen discrimination before a nation of free citizens can spend its income intelligently. The process is not an easy one, for it goes to the very roots of individual and social values, but it cannot be avoided by a people who would be intelligent in the use of their income.

Neither public nor private expenditures inherently or automatically result in social or individual benefits. One can readily think of private outlays which are far from productive, as for example, payments to astrologers or for habit-forming drugs and certain patent medicines. A close analysis of public expenditures will reveal that in general they purchase essential benefits, although exceptions occur as in the case of private enterprise.

Accordingly, there is no royal road to a decision as to what distribution of the national income should be

made between public and private enterprise. Decisions, which dogmatically assume a return or lack of return from public expenditure, reflect lack of discrimination. Intelligence requires that every public outlay be continually weighed against the difficult but fundamental criterion of general benefit.

Governmental enterprise in a democracy is not equivalent to tyrannical tax impositions by conquerors or tyrants. Rather, public enterprise is an outcome of democratic action which seeks to promote general welfare. The fact that democracy is the impelling force behind expanding public action in itself, however, does not validate a given public enterprise. Every public activity should be appraised against additional tests. Will it result in a benefit essential to the well-being of society, which will otherwise be lacking in part or in whole? Will the quality of the commodity or service produced under public auspices be equivalent or superior to that which would result from private initiative? What is the relative cost under public as opposed to private production? Are corruption and wasteful administration absent and honesty and efficient management present? Is the revenue for financing the service obtained by methods which are equitable and sound? When a state activity can meet tests such as these, it is justified. Otherwise, it is not.

"An increase in taxes has been viewed, *per se,* as an evil. Such a position is wholly an illogical one. Though governments may spend more, they do more; and it may well be that the increased demand made upon the taxpayer is more than offset by the additional service rendered to him. The really important things are not so much the grand totals of governmental revenues and expenditures as the sources from which such revenues are derived and the purposes to which the expenditures are devoted, the extent to which governments are improving their financial condition through the payment of their debts or the reverse, and the like." [8]

The foregoing considerations bear directly on the problem of financing the educational program projected in this report. This program cannot be put into action without some additional expenditures. The amount required is not large considering the nation's actual and potential productive capacity. The increased expenditures can be added gradually. The costs will, in the long run, be more than met by increases in income. The development of the program along these lines is in accord with sound economic theory.

Parks and playgrounds, schools and text books . . . yield to the public generally important satisfactions and services which they might not otherwise be able to obtain. As the years pass, the furnishings of such services out of funds derived from taxes might well be made very much more important than has been the case heretofore. The field of opportunity is here very great and the services rendered are of a fundamentally important character." [9]

Similar considerations doubtless caused Henry Carter Adams, one of the great minds which America has produced in the field of finance, to say in his *Science of Finance*: "A continual increase in the educational budget must be expected as a natural

[8] W. F. Willoughby, *Financial Condition and Operations of the National Government, 1921–1930* (Washington, D.C.: Brookings Institution, 1931), p. 3.

[9] Harold G. Moulton, *Income and Economic Progress* (Washington, D.C.: Brookings Institution, 1935), p. 100.

result of social development, and may be accepted as a normal expression of a healthful society." [10]

[10] Henry Carter Adams, *The Science of Finance* (New York: Henry Holt and Company, 1898), p. 72.

Accordingly, the Commission urges that the program proposed in this report be judged on its merits. It should be neither supported nor condemned until it has been appraised against criteria which are valid and appropriate.

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ALVIN HANSEN

Public Investment and Unemployment

MANY regard unemployment as due primarily to the failure of private investment to employ private savings. This view was presented by Professor Alvin Hansen at a TNEC hearing as follows: *

DR. HANSEN. Mr. Chairman, and members of the committee, in the testimony which I presented to the committee on May 16, I stated the problem of full employment and a high national income in the following terms.[1] I called attention to the fact about which there can be, I think, no controversy. The flow of income springs from two sources, consumption expenditures and outlays on capital or investment goods, equipment, plant and residential construction, and public construction. I called attention to the fact that the essentially dynamic source of the income stream is the outlay on expansion of plant and equipment, and on new residential and public construction.

I noted that as the outlays on investment goods of this sort rise, as employment in these capital goods industries increase, consumption expenditures also rise. That money spent in investment goods is high-powered money in the respect that its effect is magnified by reason of the induced consumption to which it gives rise.

I called attention to the fact that in a high saving, high investment economy such as ours, you cannot get full employment without large capital outlays, whether private or public. The gap between consumption expenditures and the full income level attainable under condi-

[1] For Dr. Hansen's previous testimony see *supra*, pp. 3495–3520, 3538–3559.

* *Hearings before the Temporary National Economic Committee*, Part 9, 76th Congress, 1st Sess. (U.S. Government Printing Office, Washington, 1940), pp. 3837–3839.

tions of full employment can be filled in one of three ways. First, it may be filled with private capital outlays in expansion of plant and equipment, commercial manufacturing, mining, railroad, or public utility, and on private residential construction.

Second, it may be filled with public investment in self-liquidating or non self liquidating public projects directly or indirectly productive and contributing to a higher standard of living.

Third, it may be filled by adding to private-consumption expenditures a wide variety of community consumption in the form of social services, public health, public recreation, low cost housing, and the like, thereby developing a high consumption economy. I noted moreover, that public investment may be financed partly from borrowing, especially for self-liquidating projects, and even at times for non-self-liquidating projects. Whether or not borrowing is the most appropriate economic policy depends in part upon the prevailing state of employment.

A part of public investment outlays may appropriately be paid from taxes, especially taxes which do not weigh heavily on consumption. Community consumption expenditures of the character to which I have referred ought especially to be paid for out of taxes which bear lightly on consumption. Vast capital outlays on private plant and equipment and on residential building were necessary in the rapidly expanding economy. A less rapidly expanding economy with a slower rate of population growth requires a smaller outlay on expansion of plant and equipment.

This is all the more true because a highly developed industrial system with a vast amount of plant and equipment can introduce techniques and improve and modernize its productive facilities through replacements and renewals. Evidence has been presented to this committee which shows that depreciation allowances finance under modern conditions by far the major part of gross capital outlays. A less rapidly expanding economy, in order to achieve full employment of its resources, will probably need to rely more largely in the future than in the past (1) on public investment as a supplement to private investment; and (2) on community consumption expenditures as a supplemental to private consumption expenditures.

In his testimony to the committee yesterday Mr. Berle called attention to the historical trend in this direction, and I quote two sentences:

"As development of a country progresses, I think—" he said,

> it will be found on careful examination that there is an increased need for wealth of the nonprofit type. The advance in technical, demographic, and cultural development of the country has apparently brought to the fore recognized social needs with greater rapidity than heretofore. Many, perhaps most, of these social needs cannot be handled on a price per unit basis. Their cost must be paid by the community at large, yet the productive functions of the community are better off for their existence. They therefore become the logical field for public capital financing.

To sum up, there are three roads to full employment: (1) Private capital outlays; (2) public investment; and (3) community consumption.

In the current decade of chronic unemployment, the Federal Government has been compelled to supple-

ment both private investment and the public investment of State and local governments with large capital outlays. A part of this was composed of loans to private enterprise, banks, railroads, and so forth, a part consisted of grants to local governments, a part was composed of self-liquidating public projects, a part of other forms of public works, and a part of more or less direct relief of unemployment.

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JOHN M. CLARK

Economics of Planning Public Works

PUBLIC works may be an important source of public expense, especially if they are to be accepted as a principal means of coping with a depression. This aspect is considered in the following selection from a work by John M. Clark: *

A. *Essential Elements in a Consistent Policy*

It is not the purpose of this study to deliver a final verdict as to precisely what policy must and should be followed. What can be done is to present the alternatives, and to indicate how the various factors to be dealt with are bound together, so that one can say: "If such a policy is to be followed with respect to this one part of the field, consistency requires such and such complementary policies in other parts of the field." And finally, it may be possible to present some fairly definite conclusions as to the relative importance of different features of a possible program, so that it may be possible to say: "A should be done before B. If A is not done, then it is inconsistent or unwise to attempt B." Some things may be decided as being practically necessary if any intelligent program is to be followed at all. On other matters there is room for wide difference of opinion and need of a great deal of further study before we shall be properly equipped to decide the issues involved with any large degree of confidence. In many of these doubtful cases, not merely study but actual experimentation will probably be necessary.

1. One of the most important elements of a consistent program is consistent treatment of expenditures as between durable public works and current services. The general rule

* National Planning Board of the Federal Emergency Administration of Public Works, Washington, D.C., 1935, pp. 155–162.

would seem to be that current services should be maintained during a depression before we think of expanding public works. So far as the object of a public-works policy is to increase general purchasing power in order to offset the decrease due to industrial contraction, it is an inconsistency to contract expenditures on current services at the same time that expenditures on public works are being expanded.

So far as it is merely a question of preventing outright unemployment, or of modifying distribution of purchasing power with a view to placing it where it is most needed, this general rule is subject to a certain amount of elasticity. A case may be made for transferring a certain amount of purchasing power from the class of regular Government employees to the class of construction workers, if there is a limit to the total amount of purchasing power which Government can safely distribute through its own expenditures. If the Government is already distributing all it safely can, and if there appear to be sufficient grounds for diverting some of this amount to help the construction industries and their workers, then there may be a case for some economies in the field of the regular current governmental services. The forms which these economies can take have already been indicated. In general, they cannot consistently go to the point of actually laying off public employees and creating unemployment in this field, while relieving it in other fields. Another limit which can reasonably be set is that essential public services, such as those of health, police, and education, should not be curtailed at the same time that Government is being more than ordinarily liberal in other directions. This is a definite inconsistency of policy.

This general rule of policy carries with it financial implications. It requires that public expenditures should be more stable than public revenues; and this implies that there will be deficits at certain times, which should properly be balanced by surpluses in more prosperous times. In other words, it calls for the principle of balancing budgets over a term of years, rather than insisting on a balance during each 12-month period. In the case of the Federal Government, this policy presents little difficulty during minor depressions, since the Government will, for many years to come, be in need of reducing its funded debt, and will be employing surplus revenues for this purpose, at least during times of prosperity.

During minor recessions a reduction in the rate of debt retirement will afford sufficient leeway to maintain a stable volume of current expenditures, without necessitating a deficit. Where a definite sinking fund has been already created through regular charges set up for retiring debts, these debt-retirement charges may create a technical deficit, even though there is a real surplus of revenues above current expenses. Such technical deficits are, in most cases, not a sufficient reason for curtailing current expenses during periods of moderate depression. This principle of stabilized current expenses carries with it the necessity for setting up certain kinds of fiscal machinery, such as elastic debt limits and possibly provisions for Federal aid to States and localities during serious emergencies.

2. With regard to the question of expanding public works during depressions, the principle may be laid

down that it is more important to expand public works during serious emergencies than during minor depressions. Minor depressions create less serious economic and social evils; and furthermore, they appear to have the quality of curing themselves; while major crises may reach a point at which the automatic forces of recovery lose their power to act. If it were possible for the Government, by increasing public expenditures to the utmost extent possible, and stretching its resources of credit to the limit of safety, to bring about complete stabilization of minor fluctuations in business, this would not be a wise or consistent policy to follow, since it would leave the Government with its capacity to help industry exhausted at just the time when it would be most critically needed. Thus, if public works are to be increased during depressions, it is more important to be in a position to increase them during major crises than during minor recessions of business.

3. We have already seen that, as means to stimulate general business, expenditures financed by credit are vastly more effective than expenditures financed by increased taxes of such sorts as would be available at such times. Thus consistency requires that credit policy should be coordinated with public works policy. Furthermore, the policy of raising funds for public works by the use of credit needs to be fitted in with the general policy with regard to the credit structure as a whole, and special measures taken if necessary to counteract any undesirable effects. For example, it has been noted that an unduly rapid repayment of the public debt during boom times may need to be counteracted by deflationary measures in order to forestall a possible unhealthy speculative movement in the investment market.

4. Consistency also requires that, so far as public-works policy deals with wages and prices, it should be coordinated with a consistent general policy in these matters. This implies that there should be a consistent general policy in these fields—something which has not as yet been fully worked out, but which is urgently called for if the present policies of the Government are to be organized into a consistent whole. Such a wage and price policy is an integral part of any policy looking toward industrial stabilization, and also a part of possible more far-reaching policies of economic development in general.

5. As already indicated, the kind of consistent policy toward public expenditures in general which has been laid down requires provisions for the use of Federal credit as a backing for State and local expenditures, in times of major emergencies. This is true, even if nothing more is attempted than the maintenance of the customary rates of expenditure at such times; and still more if expenditures on public works are to be increased.

6. If there is to be a policy of altering the timing of public works so as to increase the amount of such work when general business falls off, this will require machinery involving a very large increase in administrative control in this field. To a smaller extent, such an increase in administrative control will be required even if the objective is limited to the stabilizing of public-works expenditures. Even this will call for a program drawn up in advance for a term of years, and having sufficient

standing to prevent it from being disregarded by every successive legislative body (Congress or State legislatures, as the case may be). The standing of such a program will, as already noted, depend largely on the character, soundness, and thoroughness of the work which the program embodies. However, since this procedure cannot be set up except through legislative acts, it will have at least the authority of past legislative bodies behind it, and they may be slow to stultify themselves by disregarding such programs, even though no legislature can be absolutely bound by the acts of its predecessors.

B. *Optional Features of a Public-Works Program*

There are many phases of the public-works question in which the proper policy may be in some doubt, even after a decision is made on the one or two basic underlying questions of policy. Here the first thing to do is to formulate the questions at issue as clearly as possible, even where one can go no farther at present toward a final answer.

1. Should public-works expenditures be expanded in time of minor depressions, or merely maintained at a uniform rate?

We have already seen that the more important thing is to preserve a margin of resources available for expanding works in the most serious emergencies, and that if the attempt to expand public works during minor depressions threatened to be a serious drain on these reserves, it would be an unwise policy. The decision of this question will depend, in the first place, on how large the reserve margin of spending power appears to be, and secondly, on whether a policy of expansion during minor depressions can be worked out which will not constitute a material drain on these reserves. Thirdly, it may depend on whether a policy of moderate expansion during minor depressions may actually serve to increase the prospect of success when it comes to expansion during major crises.

It is quite possible to develop a program which will result in expanding public works during minor depressions without putting any heavy strain on the governmental reserves of credit. So long as a program of this sort is properly laid out and conscientiously followed, increased public works expenditures in 1 year will be balanced by decreased expenditures in other years, and the financial resources of the Government will not be progressively weakened. And the experience of such a program might be a positive advantage in developing methods and techniques which would be of use in overcoming the many obstacles which always confront such an attempt, and thereby might pave the way for more prompt and successful expansion of public works in future cases of serious crisis. On the basis of these considerations the balance of the argument seems to lie in favor of a moderate expansion of public works during minor depressions, but with no attempt to drive through a heavy program at such times. This is the kind of program which has been called the grade A type—in which a schedule of works is laid out for possibly 6 years ahead and carried out at varying rates in different years, but without altering the total amount of the program.

2. If there is to be expansion in dull times, should there be prelim-

inary contraction of public works below a normal long-term rate, during prosperous times?

While this question is put in the category of optional questions of policy, it is very likely to settle itself as things actually work out. When the present public works drive relaxes, there will automatically come a time when governments will be struggling to reduce their debts and rehabilitate their finances, while a considerable volume of public works will have been built earlier than would otherwise have been the case. In short, a part of the normal program for the 2 or 3 years lying just ahead, will have been anticipated. For both these reasons there will be a natural falling off in the rate of public works expenditure.

It seems further probable that the effect of straitened finances will last a good deal longer than the surplus of public works themselves, with the result that construction is likely to fall behind a normal long-run program during, let us say, the 5 years following 1934. Thus any program which may be adopted is likely to get under way in a period of comparative poverty when public works programs are likely to be something less than generous.

3. How far should expansion go, and just how should it be timed?

Here, again, is a question on which there is difference of opinion, but where a good deal of this difference is likely to vanish automatically when it comes to the test of action. Practically speaking, it is hardly possible to initiate a supplementary program of increased public works early enough to catch a depression in the first stages of declining business, and it is much more likely that such a program will not get under way until business is more than half-way down the slope of its decline. The question really becomes one of whether expansion should come as early as practicable, or whether it should be deliberately delayed with the idea of allowing business to reach bottom before beginning to attempt to stimulate recovery. As between these two policies, it seems clearly desirable to make the expansion as prompt as possible, consistent with waiting to be quite sure that the conditions are such as to require it. There is still a considerable margin of discretion in applying this principle, leaving much room for the personal equation.

4. Should there be permanent expansion of public works designed as an antidote to oversaving?

As bearing on this question we have seen that there is a fair prima facie case for the existence of oversaving, and a strong prima facie probability that this condition could not be corrected on any large scale by permanently increasing our public works expenditures and financing them in such ways as would be necessary. Both these prima facie probabilities remain subject to possible modification, and therefore this question must be put in the doubtful class.

5. Is relief work desirable, and if so, on what basis?

Should it be a permanent feature of policy or a regular feature of the emergency measures? Should it be limited to a comparatively small amount of work of high grade, compensated at regular wage rates with the attempt to limit it to the "elite of the unemployed"; or should it be more wide-spread? For example, should everyone who receives relief contribute some work in return for

it? Should there be a combination of these policies or a compromise between them? If unemployment insurance is set up, what will be its effect on the desirability of relief work and on the need for it and what is the proper place of the Federal Government in a scheme of relief work?

On these questions the experience of the United States in the present depression should afford a considerable amount of fresh evidence, though it may not lead to any radically new truths which had not been revealed by the long experience of earlier efforts. At any rate, it seems to be a settled thing that the present experiments in relief work will go on. Certain features of them, such as the Civilian Conservation Corps, may prove to have a permanent value, although experience may lead to changes in the form of the organization. Certain kinds of relief work are undoubtedly wasteful and worse than useless, and should never be repeated. Thus the answer to this question is likely to be neither a sweeping yes, nor a sweeping no. As to the proper place of the Federal Government in relief work, the answer which naturally grows out of our current experience is that the proper place of the Federal Government is to stand ready to take up the burden of relief work, along with the burden of relief and of maintenance of current expenses—in short, all the necessary fiscal burdens which ultimately become too heavy for States and localities, if a depression continues and is extremely severe.

6. Should Federal aid be granted to localities to support their current services as distinguished from enduring public works?

Here there will be opinions on both sides, influenced by considerations of different sorts, which it is difficult or impossible to weigh against each other with any accuracy. There is some argument for Federal grants in aid of education in ordinary times; and in times of great depression the need is obviously very much more serious. On the other hand, there is a very genuine disadvantage in doing anything to undermine the fiscal self-sufficiency of the States and localities; and the fact that some undermining may have happened already does not diminish the danger involved in carrying the process further. In short, this question is not only highly controversial but likely to remain so, with firmly convinced partisans on both sides.

7. Should the concept of public works be extended into the field of current services or should public works be narrowly construed in traditional terms of durable material structures and improvements?

Of course, a mere question of nomenclature is not in itself worth quarreling about; but the real question underlying it is the question whether a particular kind of administrative body, which has had large funds at its disposal during the present crisis and may have large funds again during future crises, should extend the scope of its operations beyond the traditional concept of public works.

On the whole, the device of extending the range of these emergency organizations beyond their natural limits, simply because they have funds to spend and there are needs to be met which lie outside those limits, is essentially a temporary makeshift. In the case of the Public Works Administration, the bad effects of extending its functions to

could hardly be given supreme authority at the start, disregarding or overriding other bodies which have the final word at present. As over against these older bodies the new one would have chief authority, if it could, largely by virtue of the soundness of its work.

2. If this program is to be carried out during major crises, it will call for fairly far-reaching measures of fiscal preparedness, such as have already been discussed in other chapters of this study. At such times even this minimum program can hardly be carried out without Federal aid to State and local budgets.

At this point serious questions of wisdom and expediency will arise, and the outcome will presumably be a compromise rather than a complete and unqualified carrying out of a program of absolute stability. Since these major emergencies come at comparatively long and irregular intervals, each is likely to be treated as a new case by the Federal, State, and local administrations which are in office at the time. But so far as a general rule can be laid down in advance, it seems proper to grant Federal aid in serious major emergencies to localities whose fiscal systems meet appropriate tests of soundness as judged by whether they are adapted to bring the budget into balance within a reasonable time, but not necessarily to balance it while the emergency is in full force.

To such localities, aid should surely be granted to the amount that may be necessary for the maintenance of the more essential current services. Even this represents a compromise rather than a literal carrying out of the principle of stabilized expenditures. But the situation is one in which some compromise of this sort is almost inevitable. This program, then, of maintaining a stable rate of expenditures up to the point at which fiscal considerations are bound to force a compromise, may be considered as representing the smallest program which could consistently be advocated.

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NATIONAL RESOURCES PLANNING BOARD

Increasing Problem of Insecurity and of Welfare Expenditures

DURING the thirties outlays for public welfare rose rapidly from a minor item of public expenditure to one of major proportions. Some aspects of this rise are considered below: *

The extent of dependence upon socially provided income in our country is not generally recognized. The Nation has prided itself on being a land of unlimited economic opportunity, in which each individual could secure for himself through his own efforts a comfortable, or even high, standard of living. It therefore comes as a surprise to most people to learn that, in any 1 month in the fiscal year 1940, about 6.4 million households, representing some 17.9 million persons, or roughly 14 percent of our whole population, received income under some type of public-aid measure.[1]

[1] The programs from which these families derived their income included general relief, old-age assistance, aid to dependent children, aid to the blind, farm security grants, WPA, CCC, NYA, employment on emergency public works, unemployment compensation, old-age and survivors insurance, railroad retirement, and railroad unemployment insurance. The numbers represent a slight overestimate because of the difficulty of completely eliminating cases where a family received aid from two or more programs.

The year 1940 was not unique in this respect. In any given month, between January 1937 and June 1940, never less than about 4.5 million households in the United States, comprising some 13.5 million individuals, were securing income in this way. This low point of the 3½-year period was reached in September 1937 during the period of greatest business recovery prior to the inauguration of the defense program and at a time of the year in which public aid is usually at a seasonal ebb. The high point was reached in March 1939, when almost 8 million households, representing nearly 24 million persons, were receiving governmental aid. Between January 1933 and June 1940, the number of persons dependent upon socially provided income ranged between about 10 and 22 percent of the population of the country.

These figures give indeed an incomplete picture of the extent to which public-aid measures affected the lives of the population. For in

* *Security, Work, and Relief Policies* (Part 3; Washington, D.C.: U.S. Government Printing Office, 1942), pp. 7–8.

the first place, they relate to specific months only. Most dependent families do not receive aid continuously, and there is a considerable turnover on public-aid rolls. It can be conservatively estimated that, in a year such as the fiscal year 1939, about one-fourth of the population at some time or other derived income from such measures. In the second place, these figures do not include three groups of persons whose livelihood was materially affected by specific governmental aid measures; namely, workmen's compensation beneficiaries, the low-income farmers who were active borrowers from the Farm Security Administration, and persons who received no other form of public aid than surplus commodities. In June 1940, for example, about 6.9 million households, comprising about 19.4 million persons, were receiving public aid from programs listed in footnote 1. Allowing for some duplication between programs, the figures were probably nearer 6.5 and 18 million respectively. Comparable data on workmen's compensation beneficiaries are not available. However, if the FSA rural-rehabilitation clients and the recipients of surplus commodities only were added, the numbers would be closer to 7.5 million households and 22 million persons.

The Increasing Importance of Public Aid

The years 1930 to 1940 witnessed a vast expansion of governmental activity in providing income to needy or presumably needy persons, which will undoubtedly stand out as a major social development of our times. While it is not too much to say that prior to 1930 no other industrial country had made so little provision for public aid, it is equally true that in no other country has so much been achieved in the course of 10 years.

The total number of persons dependent on socially provided income during the decade of the twenties is unfortunately not available. However, it was apparently so insignificant that the comprehensive report on recent social trends, inaugurated by President Hoover in 1929 made no attempt to indicate its size and devoted only cursory attention to the public programs providing for dependent persons.[2] It is inconceivable, in view of the figures cited above, that the problems associated with loss or inadequacy of private income could have been so summarily dealt with 10 years later. The growth in public provision for the economically insecure can be more clearly seen from the increase in expenditures devoted to this purpose. In the fiscal year 1913 the total governmental expenditures for public-aid programs amounted to approximately $21,000,000, and by 1932 they had only risen to $208,000,000. In 1940 the country was spending no less than $4.5 billion on public-aid programs, and in the previous year the total was even higher, $4.9 billion.[3]

Whereas in 1913 and 1923 public-aid expenditures constituted less

[2] Of a total of 1,541 pages, only 105 were devoted to social work and public welfare. Of these only 49 dealt with public-welfare activities, and much of the text was devoted to functions other than the provision of income and aid to dependent persons. (*Recent Social Trends in the United States: Report of the President's Research Committee on Social Trends,* New York: McGraw-Hill Book Company, Inc., 1933.)

[3] These figures relate to expenditures on all programs listed in footnote 1 above and also include governmental costs of workmen's compensation.

than 1 percent of all governmental expenditures, by 1933 they had increased to 6.5 percent and in 1939 to 27.1 percent. Expressed in terms of per capita expenditure, there has been an increase from $0.22 in 1913 to $0.57 in 1923 to a peak of $37.89 in 1939. A corresponding trend is observable when public-aid expenditures are placed in relation to national income produced.[4] In the two earlier years, relief expenditures were equal to 0.1 percent of national income produced; but in 1939 they equalled 7.1 percent.

The Changing Character of "Relief"

Statistical information about public-aid activities does not fully reveal other, but equally significant, developments. Although in the public mind the word "relief" is still applied somewhat indiscriminately to all the measures concerned with the provision of income to needy or presumptively needy persons, the scope and content of these measures are vastly different from those of the relief measures of the years prior to 1930. Within the compass of programs still popularly regarded as relief measures, the country was by 1940 providing for the continued education of thousands of young people and giving vocational guidance and education to many others. It was adding to its economic wealth by the provision of roads, schools, and other public buildings and equipment and conserving its natural resources by constructive and protective work on forests and rivers. Community resources were being enriched by new recreational facilities, and the health of the Nation was being improved by expanded nursing and medical services. Professional assistance was being made available to many groups of the population in the solution of their economic and social problems.

There has also been a significant change in the nature of the provision made for the economically insecure population. The concept of eligibility for socially provided income has undergone a radical change. Public thinking, as expressed in legislation or in the policies of administrative agencies, has come to interpret the term "need" more and more broadly. In many parts of the country and in many programs, governmental assistance is now available long before the individual has become utterly destitute. Through the social insurances indeed the country has openly accepted the policy of utilizing the powers of government to increase the security of persons whose need is only presumptive. By assuring a certain minimum income to covered workers in specified contingencies, the social-insurance measures aim to prevent beneficiaries from falling into the destitute class through unemployment or the disability of old age. And although the groups covered by insurance programs are, in the main, so defined as to embrace a class almost wholly dependent upon income from earnings, it is undeniable that the laws cover some persons for whom an interruption to earning would not inevitably involve recourse to some form of public aid.

Equally important is the fact that the measures taken by government are no longer confined to providing the bare essentials for physical exist-

[4] National income produced rather than national income paid out has been selected for the purposes of comparison because of the difficulty of securing reliable indices of national income paid out for the earlier years.

ence. Constructive and preventive measures play an increasingly important role. In particular, loss of income on account of unemployment is today recognized as creating a need for much more than material subsistence. It is now seen to call for assistance in securing new employment, which may range all the way from placement services and retraining and reconditioning for private employment to the provision of work opportunity by government itself.

Finally, a growing appreciation of the relationship between dependency and ill health, both physical and mental, and recognition of the superiority of preventive to palliative measures have led to another type of expansion of the activities of "relief" agencies. For it is evident that services of this type cannot normally be purchased by the public-aid population to an extent that would be socially desirable. Hence, many public agencies have developed a wide range of health and advisory services which aim to make the recipient more capable of self-support and, even more broadly, to make him a well-adjusted member of society.

The combination of constructive and preventive measures with the function of providing maintenance for those without private incomes is, of course, not new in principle. Some of the better-organized and more progressive relief agencies had developed constructive and preventive services long before the last decade. Emphasis upon this aspect of the problem of dependency has indeed been a major contribution of the private relief agencies. Nevertheless it is probably true that, with certain noteworthy exceptions, in the country as a whole constructive and preventive measures played a relatively minor role in the activities of the public agencies and that the change of emphasis that has occurred during the last 10 years is one of kind rather than of degree.

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THE TAX POLICY LEAGUE

The Extravagant Hinterland of Government

THE possibilities of economy in government through better administration and organization are substantial. The following selection * describes the confusion in our subdivisions of government. We must avoid the easy generalization that centralization is always conducive to efficiency, but it cannot be doubted that a reorganization could greatly improve the original structure.

* *Taxbits*, Vol. II, No. 5, March, 1935 [adapted]. Reprinted by permission of the Tax Institute, New York.

The frontier may have disappeared, but the backwoods is still with us and in these rural areas we find our most extravagant, because our most futile and inexcusable, governmental excesses. Rural justices of the peace getting the salaries of Supreme Court judges in Tennessee;[1] schools maintained for one pupil only in New York, Wyoming and other states; expensive road building equipment for governmental areas too small to use it for more than a few days a year in several states; sheriffs receiving in some cases as much as $100,000 a year in fees; real estate in the same area separately assessed by two or more bodies of government; taxpayers billed in longhand in order to make more work for political henchmen; the existence of thousands of unnecessary governmental units.

These are some of the many unjustifiable wastes which are all too common in American local government. The last named is of the most far-reaching significance. Out of it grow many other abuses.

Number of Governmental Units

The exact number of governmental units will depend upon how such a unit is defined. Professor William Anderson in his recent study of "The Units of Government in the United States" sets forth five tests of a governmental unit as follows: (1) a governing body; (2) power to provide some governmental service; (3) independence (i.e. not a mere department of some other government); (4) an area that does not coincide with area of another unit or with separate corporate existence; (5) power to raise revenue.

[1] T. L. Howard. *The Justice of the Peace System in Tennessee,* p. 15.

Judged by these standards it is found that there are 175,369 units of local government (exclusive of states) in the United States.

* * * *

A comparison of the Anderson and Census tabulations is given below. It must be borne in mind that the two estimates cover somewhat different categories. The Census Bureau does not include all townships, and special improvement and service districts are included only in those cases where their imposts are in the nature of property tax levies.

	Anderson	Census
States	48	48
Counties	3,053	3,057
Incorporated Places	16,366	16,389
Towns and Townships	20,262	19,980
School Districts	127,108	125,627
Other Units	8,580	2,598
Total	175,417	167,699

In spite of the different definitions of governmental units employed, the two tabulations are very similar except for school districts and "other units."

Types of Governmental Units

There is no general uniformity in governmental units below the rank of states. It is true that counties and municipalities are found in every state but neither of the terms carries the same significance in every state. In fact, in some of the New York statutes a county is considered a municipality.

According to the Census tabulation, Maryland and Virginia are the only states which are content with only these two forms of local govern-

ments. The simplicity of the Maryland and Virginia governmental patterns is further emphasized by the fact that the 24 cities of Virginia and Baltimore are independent of county government. (Baltimore is distinct from the county of the same name.)

Not only do the types of local governments vary from state to state but the terminology applied to the same form of government differs. For example, in the Southern states town means a village. The form of institution known as the New England town or the Middle West township is unknown to them. Nor has the need for such a form of government ever been felt in these areas.

The most varied as well as the most picturesque governmental terminology which this writer has encountered is to be found in the state of Maine. According to a study of "Maine Towns," by Professor O. C. Hormell, that state has the following units of local government upon which taxes are assessed: 16 counties, 20 cities, 435 towns, 22 plantations "A," 41 plantations "B," 2 plantations "C," 368 townships, 80 islands, 5 gores, 3 surpluses, 4 strips, 1 tract, 1 patent, 4 grants, 1 peninsula, and 2 points. The curious reader is referred to Professor Hormell's study for an explanation of the terminology. It may be said in passing, however, that "surplus," "gore," "strip," and "tract" have the same origin as the so-called "peculiars" in Massachusetts. Many of the above units are part of the wild lands of Maine which are unincorporated and unorganized. Property is assessed and taxes levied directly by the state.

The county is a very important unit of government throughout the entire South. The local government of New England is of an entirely different nature, which was admirably adapted to the needs of that locality in an earlier century but appears less defensible for present needs. The counties of New England are subdivided into towns. Anderson describes these towns as follows: "(1) They are small in area, usually not exceeding the thirty-six square miles of the survey township, and are usually rural, except in New England and in the vicinity of large urban centers in other states. (2) For county purposes they remain as parts of the county area, but they have a separate corporate or quasi-corporate status under general laws. (3) Their functions are fairly numerous, are partly of state-wide and partly of local interest, and are basically of a rural nature, although urban functions have been added where needed, especially in New England . . . Because of the very limited importance of county governments in New England, towns must perform services elsewhere rendered by counties. As a result, the town is a much more important and vital factor in the system of local government in the New England states than the township is elsewhere. Its functions as an agent of the state are more extensive and varied than those of the midwestern township."

Many of these units in New England are highly urbanized and would probably represent incorporated areas in another type of governmental set-up.

Some of the Central and Western states adopted the county form of government whereas others the county and town or township plan. In some states,—Illinois for example, both types have been followed to some extent. Towns or townships exist in 23 states. These are the north-

eastern and central states. These states have a total of 20,262 towns and townships—quite an amazing indulgence in a form of government which 25 states do not even find necessary.

If towns constitute a governmental extravagance, what shall be said of school districts? All but 7 of the states have independent school districts—a total of 127,108. According to the Census figures, 125,627 of these districts have tax levying powers.

We are indebted to Professor Anderson for the following description of this type of governmental unit: "The autonomous school district, organized separately from the ordinary system of local administration, is essentially an American device. England had some such units at one time, and there are examples in Canada and elsewhere, but it is primarily in the United States that the district system is now to be found. Nowhere else is it so extensive or so deeply entrenched.

"Frequently the term 'district system' is used to refer to an arrangement in which areas for school administration are distinct from and usually smaller than the counties, towns, and other local units, and have received from the state a separate corporate status and political organization. In a broader sense of the term, however, any arrangement would be included in which the school board or other authority is distinct from the other local authorities and is autonomous in the handling of school affairs. The area over which such a board presides may or may not be identical with the county, city, village, or town.

"A practical division can be made between the county, the town, and the district system. In eleven states the county is the principal area of school administration, in ten the town or township is the main area used, and in twenty-seven there is in the main a division into other districts. In few if any cases does one type of system exist in all parts of the state.

"Twenty-seven states, using the district system, with sixty per cent of the nation's population have ninety-two per cent of the school administrative areas; ten states using the town system of units have over twenty-one per cent of the population but less than five per cent of the school areas; and eleven county-unit states with over eighteen per cent of the population have less than three per cent of the school areas.

"There are thousands of school districts, with separate boards and corporate authority, that provide schools for not more than a dozen children each during the year. The average population of school districts in Nebraska is 191, in South Dakota, 201. Some of these petty districts cover but a few square miles of area, and include only a few families. Their capacity to provide educational services, never large, has in many instances been reduced in recent years to practically nothing.

"The geographical distribution of school districts follows a fairly regular pattern. The county-unit states stretch from Virginia to Florida and into the south central region as far as Tennessee and Kentucky. New Mexico and Utah also have the county unit. The town-unit system exists in the New England states, New Jersey, Pennsylvania, West Virginia,[2] and Indiana. From New York

[2] West Virginia has recently adopted the county system, but our data refer to the previous arrangement in which the magis-

west one finds mainly the district system, and the correspondingly large numbers of units. Illinois leads the list with 12,186 districts, New York follows with 9,504, and seven other states have over 7,000 districts each. Utah, a county-unit state, and Rhode Island, a town-unit state, are at or close to the bottom with forty and thirty-nine school areas respectively."

* * * *

Multiplicity of Local Units Makes Government Costly

Three major criticisms can be leveled against the multiplicity of local units now prevailing in many states. It is costly, it is inefficient, and it results in extreme variations in the tax burden as between different areas.

It appears obvious that the performance of the same functions by several governmental units is likely to be more costly than their performance by one unit if they can be successfully administered by the one unit. This supposition is borne out by the findings of research workers.

In his study of the "Costs of Township and County Government in Illinois," Professor M. H. Hunter compares the cost of county government in seven counties of Illinois with combined costs of county and township government in seven other counties of similar location, area, density of population, assessed valuation of property and amount of taxes levied. It was found that for each pair in 1929 and for each pair except one in 1925, the per capita tax levy for the total of county and township purposes was higher under the township system. The average for totals for the seven township counties in 1929 exceeded that of the other group by $1.20. The average per capita tax for township purposes was $1.09. "If the taxes levied for township purposes are omitted, then the costs of the two types of services are about the same."

Comparative data for 11 counties without townships and for 7 counties with townships (both groups of similar area and population) showed that the total taxes levied and the per capita cost were more than twice as high in the township counties as in the non-township counties. "The general indication, from the comparisons made, is that township organization adds to the cost of government without the addition of a commensurate service."

Further evidence of this character is available from the Fifth Report of the New York State Commission for the Revision of the Tax Laws (1935). Data on comparative costs of state, county and town maintenance of highways were obtained in 23 representative counties. It was found that in 14 of the counties the town costs were considerably higher than either the county or the state costs. "When this information is coupled with the fact as stated in the discussion of each county, that town maintenance is rather consistently inferior to either county or state maintenance, it is readily seen that: the town units are, with very few exceptions, giving less and spending much more for it than the county and state units, and, in the case of the few exceptions it is decidedly probable that the difference in cost is more than overcome by better service."

Inequality of Tax Burden

In larger units the extreme variations in taxpaying ability of certain

terial districts (equivalent to townships) and certain cities maintained the schools.

small areas tend to be ironed out. Conversely, the smaller the units the greater these differences will become. Official reports abound with statistics concerning the high tax rates which poorer communities must levy in order to obtain governmental services that can be provided at a low rate in more favored communities.

These variations complicate the problem of state aid and equalization programs. In some cases the only way in which tax burdens can be equalized is for the state virtually to assume support of the local unit.

Inefficiency of Small Units

Probably the most severe indictment to be brought against the present multiplicity of small governmental units in many of our states is that they are inefficient. Several of the recent tax commissions have emphasized this point. The reports of the New York State Commission for the Revision of the Tax Laws (particularly the fifth report) are replete with evidence on this point.

The following extracts from this report indicate some of the many ways in which governmental service provided by small units is less efficient than that provided by larger governmental bodies.

"Every canon of political science that history and experience in public administration has taught us in the last 100 years, and that is now recognized as fundamental and taught in our high schools, colleges and universities as first principles, is violated by the organization and form of local government in the state of New York. This is no indictment of individual officeholders; it is, indeed, not even a condemnation of a system but rather a frank recognition of a complete lack of system. For local government as it exists in New York State today is the product of patchwork on a garment the original fabric of which was woven in 1683.

"The Commission's inquiries have revealed beyond all doubt that there are certain functions which in general can be operated more cheaply and efficiently by counties than by towns. This is true of highway construction and maintenance, of the twin functions of assessment of property and collection of taxes, of police protection, and the administration of public health and welfare. It has been conclusively demonstrated in the chapter on highway administration that town construction and maintenance is costing more than county construction and maintenance. This would seem more or less obvious when we consider that the towns invest in expensive road machinery which sometimes is used only a few days each year and left to rust the remainder of the time. In one instance, a road crusher costing $5,000 was found to have been used just 17 days during the entire year by the town which owned it. But until the Commission undertook the investigation this year, there was no concrete evidence applying generally that placed the matter beyond dispute. That evidence has now been supplied."

* * * *

The Desirable Size of Local Units

What is the most desirable size of the local governmental unit? The size of the unit by which one function can be most efficiently administered is not necessarily the size that will prove most effective for another function. Obviously, also, both area and density of population will have to be considered.

It is encouraging to see that there is a substantial amount of uniformity among authorities on this subject. Professor Anderson considers that: (1) It is desirable in rural as in urban areas to have only a single important administrative unit in each area; (2) assuming the county to be the main administrative unit in rural areas, its size should be determined so far as possible by the administrative efficiency and economy of the more expensive functions (roads and schools); (3) When one of these services (roads) calls for a really large unit, and the other (schools) could be handled by either a somewhat smaller unit or equally well if not better by the same larger unit, the large unit should be preferred.

If these conclusions were followed, (1) "there would be no separate school districts in the county whatsoever. . . . (2) Practically all other special districts would also disappear. . . . (3) Townships in most of the middle western and several Middle Atlantic states would cease to exist as governing units, but might exist as areas to the extent needed for the local administrative and election purposes of the county. . . . (4) The towns of the New England states are in general in a different position from that of the township. Many of them are urban and industrial and are more like the cities and villages than the townships of the middle west. Until the counties assume greater importance in the local government of the New England states, the towns, both rural and urban, have useful functions to perform. In the meantime, a great deal of consolidation among the least populous and more rural towns would seem to be indicated by our tentative principles concerning the desirable sizes of local units. Ultimately the county might take over most of the local functions of state-wide importance. (5) For the more local and urban purposes, cities, villages, boroughs, incorporated towns, and many of the towns of New England would remain as they now are, although many of the petty villages have little reason for separate corporate existence. (6) In the main urban centers there would be the city-county type of unit, like the county-borough in England, handling all the functions of a city, a county, and a school district. (7) In rural areas, and in areas partly urban and partly rural, the county would be the main unit for performing services of state-wide import, including education, and also for providing the rural local services. It might also take over water supply, street maintenance, and street lighting for the smaller villages. The number of counties would, however, be reduced, since many counties today are too small and too poor to provide effectively for the services expected of them, and the prospects as to further population increase are very discouraging.

"The net results of these eliminations and consolidations would be to leave the local units about as follows:

City-Counties (each having a central city of at least 25,000 population)	about	350
Counties (rural and part-rural)	about	2,000
Incorporated Places (including the larger towns in New England)	about	15,000
Miscellaneous Units	about	500
Total	about	17,850

"The total here is approximately one-tenth of the number of units now in existence. The average state, instead of having about 3,700 local units, would have about 370. That such a number of local units could handle the affairs of local government is beyond question."

* * * *

A tinge of pessimism causes one to doubt whether the groups that were so active in demanding horizontal budget slashes and in fostering taxpayers strikes a year or two ago will display the same zeal in working for these more constructive and less injurious goals. The achievement of these reforms will not be easy. Our present hodge-podge of local governmental units is firmly entrenched in rural sentiment and serves many vested interests. There are numerous constant barriers to reorganization.

The obstacles are tremendous but the goal seems worthy of the endeavor. Here is a promising field awaiting the effort of the sincere advocate of governmental economy.

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WILLIAM TURN

In Defense of Patronage *

TWO views concerning the possibilities of economy through the use of the merit system in personnel management follow:

In an era which places a great deal of emphasis on the value of so-called "expert" opinion, there is something unreasonable in the hysterical indictments of political patronage which are made today with little or no actual knowledge of what it is about.

Almost thirty years of practical political experience have given me a real insight into the subject, and to my way of thinking, the attackers of the patronage system are guilty of an unpatriotic act against an inherent and necessary part of our American political system. The true cause for the introduction of the spoils system was the triumph of democracy. Today it remains the one realistic device for permitting the majority of the people to mold the policies of government.

Why Party Workers Are Needed

If the people as a whole are to have a real voice in the conduct of the government, they must be organized. What is more (and this is going to be a terrible shock to the

* Reprinted by permission from *The Annals of the American Academy of Political and Social Science,* CLXXXIX (Jan., 1937), 22–28.

starry-eyed reformers), they have to be pushed around and coaxed or dragged to the polls to exercise the hard-won privilege of the franchise. Thousands of people never vote because the registration dates pass before the campaign gets exciting, and they are not interested enough to make the effort to qualify. Others get wildly excited about issues or candidates between election days and damn the government from first to last, but forget all about their objections on election day. To prod these lazy ones into action, to insure that our democratic form of government will remain truly democratic and representative of a majority of *all* the people and not just of a selfish few, militant party organizations are essential. There must be drilling and training, hard work with the awkward squad, and an occasional dress parade.

This work requires the labor of many men. There must be precinct captains and ward leaders and district representatives. On registration days and on election days there must be telephone squads and free transportation and wide-awake generalissimos. Every day of the year there must be party leaders actively concerned with the business of the organization—keeping in close touch with the great masses of "average folks" whose participation is vital to any truly democratic process, learning what they are thinking, and interpreting for them the policies which are being put into effect.

Now, some men labor for love and some for glory. But glory comes only to a few of the most outstanding leaders; it cannot serve as a general inducement, and even those who love must live. It is an essential idea of democracy that the leaders shall be of the people. They must belong to the class that makes its own living. What then could be more reasonable than for good citizens who have displayed their ability and their devotion to the principles of democracy within their party to be picked for responsible service with the government when there are positions to be filled? I have heard it suggested that we need more training in our schools in preparation for public service; but I wonder what better training there could be than the practical lessons which are a part of the orderly and disciplined advancement in the organization? Recognition in party organizations, like recognition anywhere else, comes in proportion to good service rendered.

My own experience has been a clear record of this principle. After an apprenticeship which included such routine chores as the distribution of handbills and tacking up campaign posters, I began to learn the fundamentals of party organization as a precinct leader, and I can report my activities here with no embarrassment. The idea was simply this: I went out and got acquainted with my neighbors! When a new family moved into the neighborhood, I made myself known to them at the earliest possible moment and saw to it that they got acquainted and were taken into the activities of our community. On registration days I was an early and persistent caller, ready with information about where and how to register, helping to arrange for time off if necessary, and making up schedules to take care of those who needed transportation or someone to mind the baby.

As I proved my sincerity and ability, I was allowed to sit in on the party councils. Here I found men

who were leaders in the community and who honestly believed that the policies of our party would further the welfare of our people. They were frequently profane, but never treacherous. They met together and considered seriously the choice of candidates who would earnestly support the policies of the party and who seemed to have the confidence of the largest number of people in our community.

When election time approached, it was perfectly natural that my neighbors and I should talk about the candidates, and since my participation in the councils of the party had given me a better acquaintance with some of the candidates than most of them had, they were glad to hear what I could tell them. Some of the candidates spoke at meetings in our neighborhood, and it pleased both my neighbors and myself to follow these meetings with introductions and more informal conversations which gave them an opportunity to express their opinions and talk face to face with men who had their interests at heart. People in general are not very interested in just abstract ideas. But when those ideas are associated with Joe or Sam or Frank, whom they know as friends and leaders, then there is flesh upon the bones of democracy, and government is something which has interest and meaning.

The success of a candidate is much more than a chance to pull a plum out of the patronage pie; it is the satisfactory knowledge that the public affairs are in the hands of colleagues in whom it is possible to have confidence. When new policies are being developed, this is of tremendous importance. It is human nature to be suspicious of any change in the way of doing things, whether it is the way the new preacher begins the service, or a city ordinance allowing right turns on red lights. Without the confident and sympathetic support of the rank and file, there is a great deal of waste motion before people are ready to give the new ideas a fair trial.

Business Methods in Government

And that reminds me of the old chestnut about "What businessman would run his plant like the government?" People can get pretty excited about that, but most of them don't stop to figure out that the only condition under which that question would be pat is, for example, if a private utility company were taken over by public ownership. We have all had ample opportunity during the past few years to get a reasonably clear idea of the sentiments these two camps have about each other. Keeping that in mind, I ask you to consider what the general manager for the public ownership outfit should do about personnel. According to the reformers, he shouldn't fire any of the people in the business he took over, because some of them would have been around for thirty or forty years and knew just how their jobs should be done.

Now isn't that a pretty idea? We can assume that every employee in the business had been campaigning vigorously against the change in management. Department heads, brought up to look upon public ownership as an unwarranted invasion of private property rights would be so hopping mad and so absolutely sure that the new plan couldn't work that they wouldn't bother to open their mail. Some of the boys who had to take salary cuts

would get together on the side and start figuring out how they could spoil the show and return the business to the hands of their friends. A fine way to do business!

For the benefit of those who think "the spoils system" is something which Andrew Jackson turned loose on a previously pure and unsuspecting world, I should like to point out that the desire of leaders to surround themselves with loyal and trustworthy supporters is a perfectly natural and understandable phenomenon which is as old as time itself. The very founding of our Nation depended on the unswerving loyalty of a few daring men, and the administration of our first great President, George Washington, took into consideration the importance of placing in office those who were "supporters of the system." There is evidence, too, that this famous statesman made his appointments with an eye to geographic distribution, realizing that such action was both fair and wise. When he had appointments to make from areas in which he was personally unacquainted, he asked for recommendations from the Congressmen from those districts, because, as he very properly believed, their local knowledge gave their words special weight.

Patronage appointments for demonstrated party loyalty seem to me most likely to promote efficiency. Too light weight is given to the protection which patronage gives the government against bureaucratic sabotage, which its enemies naively deny on the theory that "the spoils" are distributed in grab-bag fashion, with those having the longest reach taking home the prizes. The occasional administrations which have ignored the principles of loyalty and fair play in distributing patronage have been short-lived. It is only common sense for an organization which wants to maintain unity and strength in its own ranks to grant recognition on a completely democratic basis.

As for the quality of the appointments, it should be borne in mind that while patronage is a reward to those who have worked for party victory, it is also the test of a party's fitness to remain in office. Every bad appointment weakens the party's power. Dr. Carl J. Friedrich, of Harvard University, reported for the Commission of Inquiry on Public Service Personnel:

> You cannot take offices with vast powers attached to them "out of politics," for politics is not a bottle or any other variety of container. Politics is the struggle for power. Where there is power, there is politics. What you can do, and what you must do, is to make politics responsible.

That is just what patronage does.

Civil Service Employees

A good measure of the value of patronage is the nature of the alternatives which are offered in its place. The greatest of these is civil service! This is a unique system under which it is assumed that people are simple organic compounds, subject to laboratory methods. Examinations are given to these specimens, and on the basis of the results they are neatly catalogued and filed until needed. Orders are filled on the general understanding that short of an Act of God there will be no returns or exchanges. The finished product is a pale, quiet individual, faithful in a dim sort of way, disinclined to originality, but capable within a limited field of an insolence that makes

one wonder why it is called "civil."

The chief advantage of the civil service system appears to be that it offers regular, light employment at a moderate remuneration. This undoubtedly attracts large numbers of steady-going, unimaginative people, but I question whether their services are of any greater value to the public than the less routine but more lively efforts of patronage appointees who have a personal stake in the business. Men and women who stay in one place too long get in a rut. Like a horse with blinders, they see in only one direction, and too often that direction is not toward the taxpayers who pay their salaries. I think it is significant that when people speak of "government employees" they almost always have in mind a roomful of clerks.

It has been my experience that a dull level of mediocrity is likely to be encountered in civil service, and it was doubtless this same feeling which led Andrew Jackson to say, "I cannot but believe that more is lost by the long continuance of men in office than is generally to be gained by their experience." A more violent friend of mine refers to the "Snivel Servants" who are so afraid of doing any original thinking that it is only after long persuasion that you can get them to agree with you that Christmas will probably be on the 25th of December next year. This man is a real friend of government workers and has done a lot for them, but their shilly-shallying ways and their unwillingness to work together for any purpose whatever try his patience.

Of course the civil service policy of forbidding all political activity to government employees is largely responsible for this attitude, and I think it is a dangerous threat to democracy. Here is a large group of the very people who should have an active voice in party councils, and they are so hedged about with restrictions that they shy like a frightened horse at the mere mention of the words "Democrat" and "Republican."

A Case in Point

This senseless insulation can have but one result—a growing chasm of misunderstanding between the government and the people it is supposed to serve. I am reminded of a case which came to my attention in one of our large cities not long ago. A janitor in one of the city buildings was crushed to death in an elevator shaft, and his wife and two children were suddenly left with no support. One of the bewildered woman's neighbors told her she could get help from the city. Another mentioned "compensation." Urged on by her friends, she made her way timidly to the City Hall and began a discouraging round of inquiry. Hurrying, self-important clerks whisked by her unheeding. Elevators clanged, and heavy doors closed firmly and mysteriously in her face. At last she found her way into an open doorway and tried to tell her story to the stuffy young man who sat at the desk there. In his eye gleamed the quick and superficial light of the passer of intelligence tests, and soon his ear caught a familiar word.

"Elevators, is it? Yes, indeed! Right down that main corridor. You'll find four of them right in the center of the building. That's right! GOOD day!"

Patiently this sad little woman kept on wandering, kept on trying

to tell her story, and arrived at last in the public welfare office. Brittle efficiency took her in charge again, asking questions to make her cry, and finally rattling off an overwhelming array of unfamiliar names —the organization that would help with the children, the office where she might find a job, the man who could tell her about compensation. Our friend smiled mistily and found her way back home, where the neighbors found her with her hands lying hopelessly in her lap.

But the news of this woman's misfortune had traveled, and early the next morning she found herself in the office of her district leader. There had been no humiliating fumbling and confusion this time, and doors had opened ahead of her for the party worker who had brought her here. She knew the district leader was an important man, and it seemed incredible that he could find time himself to listen to her small affairs; but that was exactly what happened, and when he had listened he spoke in words she could understand. He gave her cards on which he had written his name, and he spoke authoritative words over the phone. And somehow everything was taken care of and life seemed a little less full of grief. But if you had asked her who was doing these things for her, she would not have told you that it was the government!

Quality of Personnel

Quite aside from the unsatisfactory character of the type of person attracted by the civil service procedure, there is good reason to question the accuracy of an arbitrary examination (or the possession of a college degree!) as a true measure of an applicant's ability. It will be a long time before the enthusiasts for civil service examinations are allowed to forget the fiasco that was the Alcohol Tax Unit test. Questions about Socrates and Plato seldom have any pertinent application to modern office practice, and many of my readers must know of people to whom the trickery of an intelligence test is completely baffling but who are nevertheless capable of outstanding performance in a familiar field.

Patronage appointments are based on demonstrated ability in the organization, and they are the result of thoughtful investigation and appraisal which is strengthened by the knowledge that the record of the party is involved. It is my guess that the application files and the appointment procedure of the party organizations as they are maintained today would compare very favorably with those of the personnel department of any large industry and of the civil service commissions themselves!

The New System

During the present administration, a new, and to my mind a really dangerous alternative to political patronage, has come into use. This system is exemplified at the top by the Battling Brain Trust and in the lower brackets by the practice of distributing jobs on the basis of church or lodge affiliation or through a fraternity or some other avenue of personal friendship. The guiding principle of this system seems to be that to be of any use at all to the administration, you must be either completely out of the field of practical politics, or, better yet, a member of the opposite party! Commenting on this trend, Congressman Ramspeck,

chairman of the House Civil Service Committee and a strong advocate of the merit principles, hit the nail on the head when he said, "If I make a patronage appointment, and it is a bad one, my constituents have their redress. The way things are now, there is no comeback against bad appointments!"

The ill-starred Brain Trust provides an unhappy example of the dangers of ignoring party responsibility. Few people today subscribe to the old-fashioned doctrine that any honest fellow with ordinary horse sense can fill any job in the government. The complexity of our own invention has sufficiently impressed us all. But there are men of brains, men who are economists and planners and experts, in both parties, and their presence in the parties indicates that they have some acquaintance with the practical problems of public administration and a capacity for unselfish support of a chosen leader.

Too many of the men who have been running our affairs of late have been impractical visionaries who were breathlessly excited and childishly quarrelsome over an opportunity to have a great nation turned over to them for experimentation purposes. Unlike their well-meaning sponsor, they were not unconscious of the value of effective support, and they drew into their charmed circle an admiring chorus of instructors and favorite students, so that as the endless chain lengthened there was something very pat in the cartoonists' portrayal of them as "the Frankfurters"! Loyal to no interests but their own, they engaged in shameless name-calling all over the front pages of our national dailies, and played at chess with human suffering.

It is no wonder that the original ideas adopted in the party platform became perverted in the hands of these men, prompting a caucus of responsible party leaders in Congress to send to the President a resolution which reported to him that they had

> received complaints of the alleged inefficiency, arbitrary attitudes and unfitness of some of the personnel in these organizations [and had been told that] men in responsible positions are unsympathetic and therefore ineffective in performing the duties with which they are charged, and . . . that in some districts the Agricultural Credit Administration is so unsympathetically administered as to deprive farmers of that prudent and just degree of relief the act was intended to afford.

This unprecedented performance illustrates very clearly the extent to which the interests of the dispensers of patronage and the interests of the public are bound up together. Let us assume for the sake of argument that all the men who met and drafted the above resolution were high-handed politicians, hungry for more jobs for the party. The charges of inefficiency would disturb them because an angry electorate might well turn the party out of office. The unsympathetic administration would mean the defeat of their program.

And then let us assume that all those gentlemen were high-minded idealists, willing to make any sacrifice for the good of the public welfare. The charges of inefficiency would disturb them because they might be turned out before they had done their job. The unsympathetic administration would mean that they were not being given a fair chance to prove that their program was right. In both cases the final result is the same!

Room for Improvement

The enemies of the patronage system are willing occasionally to admit that their systems are not the perfect answer, and I will be equally magnanimous and admit that the patronage system could be improved. A great forward step has already been taken in the distribution of patronage. In the old days, there was an element of gamble in the assignment of jobs. There was more of the "first come, first served" philosophy, and a good-natured rivalry between leaders occasionally resulted in extra portions for the more aggressive. But closer organization and better discipline have led to a merit policy which seems to me to offer the best possible service to the public. The most important single factor in its betterment would be a more active participation in party councils by the people who are doing most of the talking about what is wrong! Our government is not going to get any simpler as time goes on, and the need for experts in the field will increase; but if their contribution is to be realistic *and responsible,* they must first learn the elementary lessons of democratic control as exemplified in the political party.

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JAMES K. POLLOCK

The Cost of the Patronage System *

In his brilliant address before the annual meeting of the National Civil Service Reform League in Chicago in 1894, Carl Schurz observed:

> It is indeed almost incomprehensible how the spoils system could be permitted through scores of years to vitiate our business methods in the conduct of the national revenue service, the postal service, the Indian service, the public-land service, involving us in indescribable administrative blunders, bringing about Indian wars, causing immense losses in the revenue, breeding extravagant and plundering practices in all Departments, *costing our people in the course of time untold hundreds of millions of money,* and making our Government one of the most wasteful in the world.

In the forty years since these remarks, government in this country has come to be a much more important, complicated, and all-pervasive thing than it was in the early nineties. Hence where Carl Schurz could speak of hundreds of millions, we today would have to speak of billions. Where in his time a few services existed, today hundreds of services are performed for the citizen—and many of them, as in Carl Schurz'

* *Ibid.,* pp. 29–34.

day, under the "spoils system in finest efflorescence."

"Untold hundreds of millions of money" have been and continue to be wasted under our patronage system. And although we have learned to calculate the cost of crime, we have only begun to calculate the cost of patronage. Despite the fact that these patronage costs are almost beyond calculation, and even though one cannot make a perfectly correct balance sheet, it is possible to indicate the items of loss which are directly attributable to the spoils system.

Patronage costs may be listed under three heads: losses of a general, moral character; losses to political parties; and losses in public administration.

Moral Losses

As to the first item, a considerable amount of the lack of confidence in government is traceable to the system of choosing public officials on a political and not on a merit basis. In many jurisdictions in the United States, the very fact of a man's being a public officer or a politician brings suspicion upon his integrity and his manhood. The public assumes that public office involves a sacrifice of one's ideals and principles and a lowering of one's standards of efficiency. For every example of shining, sterling public virtue, the citizen is reminded of many instances of barter of jobs, graft, and general governmental looseness. Basically these public exhibitions of inefficiency are always traceable to some official, and since the majority of public officials are still selected on a patronage basis, the system under which they are selected must be fundamentally to blame for our lapses from governmental excellence.

As long as elections are ugly struggles for place, as long as we continue to put elections on a venal basis—"you vote for me and I'll give you a job"—just so long will the whole moral level of our politics be about as high as the standards of bribery will admit. As long as campaign funds can be extorted from politically appointed office-holders, as long as public officials can be forced to work servilely for their parties, as long as public offices can be handed out over the counter as rewards for political service, just so long will we have a discreditable moral atmosphere surrounding our politics.

There is of course no ascertainable figure of loss to the democratic system. But with moral values, we are not concerned with dollars and cents. It should be sufficient merely to point out the undoubted facts.

It has often been contended that patronage is a necessary aid to political leadership in this country. But it is interesting to note that many of our greatest governors—Grover Cleveland, Robert Marion La Follette, Judson Harmon, Hiram Johnson, and Albert Ritchie, to name a few—men whose political leadership was undoubted and of a high order, were not merely advocates of civil service but were responsible for its establishment in their respective states. In Great Britain political leadership is all the stronger for being relieved of the sordid patronage duties which bog down the average American political leader. Gladstone was grateful that the only job he could fill was that of his own private secretary.

Losses to Political Parties

So far as the parties are concerned, it should be clear to wise politicians

that the barter of jobs prevents them from functioning properly as formulators of public policy. They are so engrossed with the task of handing out the loaves and fishes that they have no time for their most vital function in the democratic state, namely, the formulation and discussion of public policies. They have assumed that patronage is a necessary instrument with which to gain control or keep control of the government. But the instances are now multiplying to show what a genuine detriment to the party the spoils system really is. For every appointment which is made, perhaps a dozen disappointed persons are made to grumble—the one appointed in many cases becoming an ingrate.

The incompatibility of spoils and proper party activity is well pointed out by Professor Merriam,[1] who has said that

> our political parties are strongest in the national field and weakest in the local situations. In other words, the spoils influence is least prominent where there are sharpest differences upon questions of policy, and most pronounced as we go farther from genuine party differences. As party principles and policies rise, the spoils system sinks. The party system and party spirit do not need spoils. On the contrary, they are incompatible; and the stronger is the one, the weaker is the other.

How true this is may be learned from a cursory glance at our political history. If patronage is necessary to keep parties alive, how has it been possible for the Democratic Party to survive? This party has elected but three Presidents since the Civil War, and it lost its hold on the government in 1888, in 1896, and in 1920 when it had the patronage power in its hands. As Senator Vandenberg has remarked, "If a political party cannot survive without patronage, it ought to die."

But enough has been said to indicate that the loss to the party and hence to the state under a patronage system lies in the party's failure or inability to serve as an agency of civil education, as a genuine formulator of public policy. When jobs are to be filled there is no time for discussions of public policy. There is no dollars-and-cents value to this item, but it must be entered in any general balance sheet of patronage losses.

Losses in Public Administration

The most concrete instances of loss to the people of this country arising out of our spoils system may be found in the operation of our public services. In public administration, specific items of cost may be enumerated and a clear conception of the wastefulness of the patronage system pointed out.

First of all, the cost of turnover in the public service is considerable. The recent report of the Michigan Civil Service Study Commission has shown that for a ten-year period the average annual number of new employees amounted to 25 per cent.[2] This means that one fourth of the Michigan State service has been new each year. The annual loss in experience occasioned by this excessively high turnover was estimated at half a million dollars. Many businessmen have a figure—a thousand dollars—which represents to them the cost of breaking in a new employee. A sys-

[1] *The American Party System* (rev. ed.), p. 133.

[2] Report, *Civil Service Study Commission* (Lansing, 1936), pp. 42–44.

tem which changes one fourth of the employees every year is indeed an expensive system when figured on any fair basis. Frequent changes in public positions, common in all parts of the country, cost the taxpayer a very sizable sum every year —a sum which few business concerns would tolerate or would be able to pay.

Another loss under the patronage system is occasioned by loose payroll practices. The usual spoils system is not interested in a careful check-up of positions on the payroll. The spoilsman is interested only in getting as many noses in the public trough as possible. Even if fictitious names should appear on pay rolls, even if pay-roll padding should be indulged in, he is not concerned. Consequently the waste of public money through pay-roll padding, or through embezzlement, is considerable. A few hours in a good public personnel office will be sufficient to convince a taxpayer that the pay-roll check, which is always a part of any good civil service system, saves thousands of dollars. One state personnel executive estimated the annual saving in his state at $100,000.

Under most patronage systems there is also discoverable an absence of careful supervision over hours of work, vacations, and sick leave. When an employee gets a job on the basis of political influence, he is likely to hold it as long as his political sponsor desires. What kind of work the employee does, how regular he is in his hours of work, whether he stays away from his work for days at a time, are matters which may irk his administrative superior, but that official can do little or nothing about it. There is no incentive under the patronage system to check upon employees to see that they give efficient service. To antagonize politically influential employees is to incur the wrath of politicians who are quite able and willing to destroy department morale in order to perpetuate their influence. Very incomplete figures taken in several jurisdictions show that public agencies lose large sums of money along these lines.

Inexperienced Employees

Not the smallest loss under the patronage system is attributable to the inexperience of many government employees, especially in state and local governments. Recent surveys have shown that as high as 25 per cent of the employees in various jurisdictions have never held other positions before entering government service. The Michigan survey discovered that stenographers who were hired as finished performers were going to night school to learn how to run a typewriter. When ex-convicts can become prison guards, when eighty-year-old people are intrusted with work requiring considerable physical activity, when purchases are made by persons never before charged with spending large sums of money, when welfare tasks are handed out to persons untrained in social work, one can see the cost to the taxpayer in both dollars and service. The citizen pays for courteous, efficient service. He rarely gets it under the patronage system.

But such inexperience in routine positions is not the worst feature of patronage. Today governments are concerned with regulating many business activities. They assess large properties for taxation, they collect taxes from enormous businesses, they inspect business activity, and they administer much regulatory legisla-

tion. In performing these functions, public employees run up against the best brains of modern business and industry. In these contacts it is sometimes pitiful to learn how poorly the public employee fares. He is too frequently no match at all for the competent, trained business employee who is not harried by political diversions. Think of an auditor for a sales tax division who has never had a course in accounting! Contemplate a workmen's compensation investigator whose appointment was secured by the influence of the businesses with which he must deal! Reflect on a highway inspector who is putty in the hands of an experienced road contractor!

Fortunately many government employees are able to meet their clients on an even basis. They would always be able to do so if modern public employment methods were permitted to be established. Until such time, however, government will continue to lose untold millions because many of its employees are "taken in" by shrewder persons in private employ.

Political Demands Upon Employees and Administrators

In the next place, government employees under a patronage system are unable to perform their public services without political interruption. Employees who are politically appointed are naturally expected to attend political meetings, make speeches, canvass voters, and do all the other things involved in political activity. Some government offices might as well be closed during a campaign as remain open. Work is disorganized because employees are out on political jobs, and because the few who remain are not going to overwork themselves when they are not sure about their jobs after the election. As Carl Schurz once remarked: "The school of the spoils system as it has been in operation since 1829 has educated thousands of political loafers but not one political sage."

Another political practice arising out of the patronage system is the plan of raising campaign funds through the assessment of public employees. "Two per cent clubs" manage to squeeze out of politically appointed employees large sums of money to help defray campaign costs. The public pay roll is thus used in an indirect way to pay party expenses. Hundreds of thousands of dollars are collected in this way.

Even between elections, a considerable amount of time is spent by patronage employees in keeping political fences in repair. Influential politicians must be received and entertained, and favors must be done for others. Public business must be laid aside when friends or parties call.

Another serious indictment of the patronage system can be seen in the loss of time to administrators in the handling of patronage matters. Governors, department heads, appointing authorities of all kinds are wailing about the burden of distributing patronage. At times they are peddlers of offices and nothing more. At the commencement of a new administration they are besieged by office seekers not merely at the seat of government but also at their homes or at any other spot where they happen to rest for more than a moment. The picture of a newly elected governor surrounded by hungry job-hunters is one of the most disgusting features of American political life. To see legislators running

around like whipped errand boys, and department chiefs unable to become acquainted with their work, is a sickening sight. Even the creation of official patronage offices does little to lessen the burden of executives, for such patronage counters tend to attract more office seekers. It is no wonder, under such practices, that our chief executives and principal administrators are frequently unable to do a good public job. The scramble for jobs must take precedence over the public business.

As President Andrew D. White of Cornell remarked as long ago as 1882:[3]

> The complaints against the present system may be summed up nearly as follows: first, that the petty interests of a comparatively small number of citizens constantly encroach upon the most important interests of the entire Nation; that a large share of the labor and care of the executive and legislative branches of the government is confiscated by a petty minority; that the system has at last in this respect become intolerable.

The famous quotation from Lincoln in this regard deserves repetition: "It isn't the rebellion that is killing me—it isn't the rebellion; it is your plagued Pepperton post office." And the remark made by General Garfield at Williams College that one third of the working hours of a senator and a representative is hardly sufficient to meet the demands made upon them in reference to appointments for office, could be repeated today if Congressmen were as frank.

Wasteful Handling of Personnel

But to continue the enumeration of specific counts in the indictment against the patronage system, let reference be made to the costliness of handling the personnel problem without an adequate classification of employees and without an adequate compensation plan. Where employees are not properly classified and compensated, it is impossible to give equal pay for equal work. Many employees are overpaid; many are underpaid; and altogether, a bad morale necessarily exists. In dollars and cents, classification pays. In morale, it contributes greatly toward making public services more efficient.

Again, it should be pointed out that nearly every spoils jurisdiction is overstaffed with employees. There is no incentive under the patronage system to reduce the number of employees. The more positions there are, the more faithful followers can be accommodated. Administrators in their franker moments will admit that they have as many as a third more employees than would be required if they could go into the market and select the ablest persons available.

Along the same line is the waste occasioned by the practice of keeping old employees in the job while new employees are being broken in. Such a practice, however necessary it may be under the patronage system, results in a great increase in the pay roll and a consequent loss to the taxpayers. A much cheaper educational plan could be established.

Another obvious loss to American citizens in maintaining this "oligarchy of stipendiaries" is the failure to cash in on our educational investment. We pour out hundreds of millions of dollars a year to educate our young people. Millions are expended to support institutions of higher learning in the training of doctors,

[3] North American Review, CXXXIV (Feb. 1882), 112.

lawyers, engineers, and specialists of all sorts. And yet an infinitesimally small proportion of the best product of our educational system goes into public service. The cream of the educational crop, instead of being skimmed off and placed in the service of the state, enters private life, and many of the undesirables gravitate toward government. Until government is made a career, it is natural to expect many of our able young people to be attracted elsewhere. Clearly, that system is wasteful which fails to attract and hold the finest products of our educational system.

Unbusinesslike Methods

Furthermore, the patronage system has much to do with preventing businesslike methods from prevailing in the public service. If such methods could be established, many jobs would be eliminated; therefore spoilsmen are not interested in permitting too much efficiency. Reorganizations of administrative structure in most cases would result in many desirable consolidations, thus eliminating units and also many employees. Politicians therefore put their thumbs down on such reorganizations.

Finally, it should be noted that the spoils system is a splendid weapon with which to favor one's friends, not merely in the matter of offices but, perhaps more important, in the award of contracts, in the purchase of supplies, and in the issuing and enforcement of regulations. Weakness in the enforcement of law, locating the deposit of public funds —these and other powers of public officials are utilized by spoilsmen to perpetuate themselves and increase government cost.

The patronage system may therefore be termed profligate. The imposing list of items entering into our balance sheet against the spoils system gives concrete evidence of what we are paying to maintain a system which has no place in an efficient democratic state.

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ROY BLOUGH

Federal and State Grants-in-Aid

AN INSTITUTION of great and growing importance in the field of public expenditures is the grant-in-aid. Some of the problems arising from the use of grants are discussed in the following selection: *

* *1936 Proceedings*, National Tax Association, pp. 266–274.

For years the attention of the National Tax Conference has been directed to the serious predicament resulting from the conflict of four factors in taxation. These are, first, the shift in the forms of taxes from those suited to local administration to those suited to central administration, second, the increasing state-wide and nation-wide interest in certain local governmental activities, third, the belief in local administration and decentralized government, and fourth, the traditional belief that the unit of government administering a function should, to assure efficiency and economy, be financially responsible for supporting that government. These factors are essentially irreconcilable, which accounts for the extreme difficulty of finding a public policy that will be generally satisfactory.

Programs such as the one this afternoon are part of the large amount of thinking, talking, and experimenting that must take place in making something like a satisfactory adjustment among the four factors. When the smoke has finally cleared away, if it ever does, the outcome that will probably be seen is that no single measure or line of approach has been used in making the adjustment, but that there have been compromises on all sides and perhaps some new inventions. There will probably be some increase in the centralization of government. However, more tax decentralization than some people wish will probably remain as a means of protecting government from an undesirable degree of centralization. Methods of transferring revenues from central to local units of government will probably be developed through more efficient procedures than exist today.

One of the methods of paying revenue from central to local units of government is that of the grant-in-aid or subsidy. A cursory examination of the proceedings of national tax conferences reveals that little attention has been given in past conferences to grants-in-aid. However, an extensive literature has been developing on the subject, especially in the field of public education, and the scope of the subject has grown far beyond the possibility of treatment in a single paper. It is necessary, accordingly, to limit this paper to some narrow phase of the general subject of grants-in-aid.

The basis adopted for limiting the paper is that of the purpose or objective of the grant. There are two general classes of objectives in the payment of grants-in-aid, namely, control and financial assistance. The payment may be for the primary purpose of securing to the grant-paying government the power of controlling certain activities of the grant-receiving government. This control may be of two types, first the stimulation of the receiving governmental unit to carry on an activity that the central or paying government is desirous of having it perform, and second, the setting of standards of service, personnel, efficiency and the like for the performance of the activity. It will probably be agreed that in the history of grants control has been the usual primary objective. If, however, the payment is for the primary purpose of rendering financial assistance, the objectives sought may be either to supplement inadequate revenues of local units in general, or to equalize the tax burdens of different grant-receiving local governmental units

in the performance of the specific function in question.

At this point it may be parenthetically remarked that since both state and federal aids are being treated the term "local unit" refers to the unit receiving the grant, that is, to the school district, township, city, or county in the case of state grants, and to the state in the case of federal grants. "Central unit" refers to the unit paying the grant, that is, to the state or federal government as the case may be.)

To the writer the most difficult and probably the most significant financial problems of grants-in-aid for the relatively near future center around the objective of equalization. Attention is accordingly concentrated on certain questions that arise whenever equalization by grants-in-aid is considered. It should be unnecessary to state that by no means all of the questions involved will be even mentioned.

Question 1. *Through what form of grant-in-aid can equalization be accomplished by the smallest aggregate amount of grants?*

Grants-in-aid are usually distributed on a fixed percentage or on a variable percentage basis. In the fixed percentage grants a uniform matching contribution, for example, two-thirds, is required of every receiving unit. In the variable percentage grants the percentage required of the local unit having small ability to pay taxes as compared to its need for the services receives a larger grant in proportion to its own contribution than does the local unit with large tax-paying ability.

Fixed percentage grants should (unless deliberately designed to the contrary) accomplish some equalization of tax burdens among the governments to which they are paid. Most grants are made on the basis of need for the particular service in question, however roughly and inadequately need may be measured. The portion of the cost of performing the service that is paid by the grant is financed through uniform taxes imposed over the whole area of the central government. To the extent that such taxes fall in accordance with geographical ability to pay, the grant produces geographical equalization. One exception, which in some cases may be important, should be noted. If the local unit (that is, the receiving state or locality) is unable to finance its share of the cost of an activity for which a grant is given, it cannot participate in the grant and since its residents must contribute to the payment of general taxes from which the grants to other states or localities are financed there is an increase in inequality of tax burdens rather than a decrease.

In the case of the payment of variable grants, the extent of the equalization may be much greater than the amount of the grant, and should always be greater if there is any adequate measurement of need for the governmental service and of the ability of the receiving unit to pay for that service.

The way in which the variable grant results in equalization may be seen from the following illustration. If the wealthiest local governmental unit has twice as much tax-paying ability in relation to the cost of the needed amount of the service in question as does the least wealthy local unit (with the wealth of the other local units falling between the two extremes either uniformly or on some symmetrical curve such as the

normal frequency curve), and further, if the central government contributed for the aggregate of all local units one-fourth of the cost of performing the governmental service; and finally if this contribution were distributed in the form of grants in such a way that the wealthiest unit received no grant and the poorest unit received a grant equal to 50 per cent of the cost of the service, complete equalization of the tax burden for this particular service would result. A fixed percentage grant, however, would have resulted in only one-fourth of complete equalization. To secure complete equalization by fixed percentage grants it would be necessary for the central government to pay the total cost of the service.

Accordingly, where the objective is equalization, the variable percentage grant can be used to accomplish that objective with the least total or aggregate grant.

Question 2. *What information concerning need and ability is necessary to achieve equalization through variable grants?*

Grants-in-aid whether variable or not require some measurement of the need for the governmental service or activity in different local units. Sometimes the measurement may be a very rough and presumptive one such as population. Grants having financial assistance as their primary objective require for satisfactory administration a careful measurement of need. Thus in the field of public education one of the steps in the development of a grant policy has been the designing of methods of measuring relative local needs for educational service.

In the administration of variable grants intended to achieve equalization, however, it is necessary also to measure the tax-paying ability of different local units since the amount of the grant to each unit depends not only on the need for service but also on the ability of the unit to pay for that service.

There are essentially two approaches to the problem of measuring ability. One is for the central unit to require the local unit to prove its absolute inability before paying it any share of an equalizing grant. Any balance needed, within limits, above the amount contributed by the local unit before it reached the point of absolute inability is paid by the central unit. This method was not unusual in earlier weak school district grants in the United States. Reconstruction Finance Corporation loans for unemployment relief and the early Federal Emergency Relief Administration discretionary grants appear to have been allocated with this type of measurement in mind. States have often followed this method in dealing with localities in the case of emergency relief. For example, the Ohio Relief Commission a fortnight ago ruled that only "distressed" counties might share in the state relief adjustment fund.[1]

The assumption underlying this method of absolute measurement is that there is a determinable point of absolute inability. This assumption may be well founded in the case where a state government rigorously sets limits on the amount that a locality may raise or on the tax rate that it may impose for a particular purpose. In the absence of such limits—and in the case of the federal relationship to the states there are no such limits—however, there is no

[1] Cincinnati *Times-Star*, September 16, 1936.

determinable point at which the ability of a governmental unit to finance any given activity is zero. The absolute ability of a state or local government is determined to a very large extent not merely by the capacity but by the willingness of its people—their willingness to retrench on other activities in order to spend more on the one in question, their willingness to sacrifice in order to pay taxes, their willingness to have the government borrow to the limit of the market. The use of absolute inability as the method of measurement encourages unwillingness and the pauperization of a community, giving it an incentive to plead poverty in order to secure extra grants.

The other approach to the problem of measurement is that of measuring relative abilities of governmental units. In comparing abilities the immeasurable factor of willingness need not be taken into consideration since under this approach no effort is made to force any local unit down to its last dollar. The problem is thus one of measuring relative taxable capacities. This method has been employed in the more recent forms of state aid to public schools. There are at least two possible techniques for estimating the relative abilities of geographical areas. One of these is to determine the relative basic economic capacity on which any tax system must rest, by measuring the income and wealth of the local units. Certain logical difficulties to such measurement exist. One is somewhat analogous to the problem of domicile and situs. Is the tax-paying capacity of a geographical area dependent on the goods and services produced within its boundaries or on the income of persons living within the area? A second logical difficulty is present in determining to what extent current income measures taxable capacity and to what extent accumulated wealth measures taxable capacity. These are as yet unsolved theoretical problems that materially affect the accuracy of any measurement of ability by the method of determining basic economic capacity to pay taxes.

The second possible technique of measuring relative ability is to assume a model tax system and to apply that system hypothetically to the different areas in question, computing how much revenue would be raised thereby. Professor Newcomer's index of tax-paying ability is based on this technique.[2] It surmounts in part at least the logical question relating to income produced within the state and income received within the state, by taxing both in so far as the Supreme Court permits and the model system provides. There is, however, another and perhaps equally serious logical difficulty to this method of measuring ability. What emphasis should be given to the different taxes in the model system of taxation accepted as standard? The relative emphasis on property, income, and sales taxes, for example, will have a considerable effect on the determination of the abilities of different jurisdictions. Again there is the difficulty whether the model tax system chosen will yield the amounts computed in case some jurisdictions do not employ some of the taxes included in the model system and succeed thereby in enticing some of the more migratory forms of industry and capital from the states imposing such taxes.

[2] Mabel Newcomer, *An Index of the Tax-paying Ability of State and Local Governments* (New York, 1935).

In using either technique the impact of federal taxes and their effects on state and local revenues must be taken into account. The difficulties are perhaps more significant theoretically than practically. Computations by different fairly balanced methods give results that are not impossibly far apart for practical use. More serious is the lack of adequate data by which measurements of ability may be made year after year. Some information on income and wealth are available in federal censuses at considerable intervals. Much of the information needed is not available at all. There is a serious need for more and better year-by-year statistics of income, wealth, sales, and other economic factors in order that a more reliable and adequate measurement of ability may be made.

Another problem present in measuring ability arises in case an activity requires the imposition of a heavy tax burden. The types of measurement mentioned above do not reflect temporary conditions that may seriously affect the financial ability of jurisdictions. Examples are droughts, long and important strikes, or the shutdown of important local industries. Some consideration must be given these temporary factors in measuring ability when heavy tax burdens are involved.

Within individual states the measure of ability for the distribution of equalizing grants-in-aid has ordinarily been the value of property, as reflected in property assessments. To be of any value assessments must of course be equalized by a state body. This necessity constitutes a strong reason for good state property equalization. At best, however, property is scarcely a satisfactory measure of ability. There are two reasons why it is used in the case of state grants-in-aid. One is the lack of any better information concerning the tax-paying capacities of such small areas as school districts, townships, cities, or counties. The other is that local taxes are levied almost entirely on property and the use of any other measure of local ability would result in inequitable burdens being imposed on property owners not possessed of other ability. Since localities have no choice of their types of tax, either legally or practically, the property measure of ability is perhaps the best available in the case of state grants-in-aid to localities. It should go without saying from the preceding discussion that property is not a suitable sole basis for measuring ability in the distribution of federal grants.

Question 3. *What are the merits of variable equalizing grants-in-aid?* As compared to other forms of grants-in-aid or to shared taxes variable equalizing grants-in-aid give assurance that every state or locality to which the grant is given will be able to perform the service in question. In the case of fixed percentage grants the states or localities that need assistance the worst may be unable to take advantage of the offered grant because of a lack of fiscal ability to contribute the required matching percentage.

As compared to either local financing and local administration on the one hand or central financing and central administration on the other hand, the equalizing grant-in-aid makes possible a combination of centralized financial responsibility and local administration.

Question 4. *What are the defects and dangers of equalizing grants?*

Three difficulties involved in the use of equalizing grants may be noted. The first is that since the financially weaker governmental units may receive a very large proportion of the total cost of some service a certain amount of central control will be necessary to insure efficient spending. Without such control the unit receiving the grant may not have a sufficiently large financial stake to insure efficient administration. On the other hand, the amount of central control imposed may become so great as to nullify one of the purposes of the use of grants which is to maintain local interest, initiative, and administration.

A second difficulty with equalizing grants is the tendency to discourage any adjustment or reorganization of local units to increase their financial abilities or to reduce needs and consequently to reduce the amounts of the grants received by them. To obviate this, some central administrative discretion to withhold grants when local reorganization would make them unnecessary appears desirable.

A third difficulty with equalizing grants relates to the type of service or activity financed by the grants. Unless the activity thus financed is one of considerable general interest —that is, state-wide or nation-wide interest as the case may be—equalization places an unjust burden on the wealthier areas by making them support activities that have a purely local benefit in the poorer areas. Not only is this an injustice but it results in an economically bad allocation of funds. The best allocation of capital, business, and population geographically is encouraged by having every area stand on its own financial feet so far as matters that are of interest only or primarily to itself are concerned. For this reason the use of shared taxes—as distinguished from grants-in-aid—for the purpose of equalization is ill-advised, since such funds may ordinarily be employed for purposes that have merely local as distinguished from a general interest.

Question 5. *Under what circumstances is equalization most suited as an objective for grants-in-aid?*

In writing on fiscal relations in Germany, Professor Newcomer has pointed out[3] that the increase in tax burdens and the decrease in the tax base following the War made it impossible for the governments to make ends meet except through "uniform taxes and unified administration." Under such circumstances equalization through either grants-in-aid or shared taxes becomes almost a necessity of governmental solvency.

Such a situation, however, does not exist in the United States. Equalization—always to be distinguished from mere financial assistance given by a central government to local governments generally—is likely to be employed when two conditions coincide. The first condition is that there be a strong general interest—state-wide in the case of state grants to localities and nation-wide in the case of federal grants to states—in the performance of some governmental service or activity, which, however, for various reasons it is desired to have administered by the more local governmental unit. The second condition is that there be a wide variation in the abilities of the governmental units receiving the grant

[3] Mabel Newcomer, "Equalization of Local Government Resources in Germany and England," *American Economic Review*, XXVI, Supplement (March 1936), 182.

to finance the governmental service or activity in question.

These two conditions were first recognized to exist in the field of public education. There is neither time nor need to review the rapid growth of state equalization grants for schools. Recently there has also been some agitation to establish federal grants for equalizing school burdens among the states.

The two conditions of general interest and unequal ability to meet needs were recognized also, although with great reluctance, to exist in the case of relief during the depression. As previously mentioned, the loans of the Reconstruction Finance Corporation for unemployment relief and most of the grants of the Federal Emergency Relief Administration for the same purpose were apparently distributed with equalization as well as merely federal assistance in view. Likewise the state distributions of federal and state funds for emergency relief were usually distributed, at least in part, with a view to rough equalization, while a few states, notably Wisconsin, followed a carefully devised plan of equalization.

With the exception of Illinois, no case has come to the writer's attention where state funds for old-age assistance, mothers' aid or blind aid have been distributed on an equalization basis. The federal grants for these purposes under the Social Security Act do not have any special equalization characteristics, although some of the minor federal grants for public assistance under that act may be administered as equalizing grants.

In the field of public assistance of which these are examples, however, the conditions giving rise to equalization exist in large degree. The lines along which civilization is developing point to an increase in the use of public funds for pensions and assistance of other kinds. The interest in these matters is becoming less local in character and more statewide and nation-wide. The inequality of tax-paying ability in different states and different local units within the states is very great, greater perhaps than any of us can realize. Accordingly, an increasing interest in the equalization objective for federal and state grants-in-aid of public assistance may be anticipated. Without special equalizing grants it is probable that many states and localities can have these forms of economic security on only an extremely narrow scale, if at all.

Question 6. *Along what lines is further study in the field of equalizing grants-in-aid needed?*

Five types of further information are needed to make equalizing grants-in-aid as successful as they theoretically might be.

First is further information on the extent of state and national interest in locally administered activities. Thus far the determination of such general interest has been largely a matter of qualitative analysis. There have been no clearcut bases for determining the relative importance of general and local interest or the extent of the area over which the general interest is general.

Second is further information for use in constructing measures of the need for certain governmental activities. The information required will differ for each type of activity supported by grants-in-aid.

Third is further information for use in constructing measures of relative tax-paying ability. Both theo-

retical work and statistical work need to be done. The federal statistics relative to wealth, income, and other elements relating to taxpaying ability should be greatly expanded so that frequently compiled figures, broken down by geographical area and by kind or source, will be available.

Fourth is the further development of techniques of administrative control that will insure efficiency and an adherence to standards without destroying local interest and local government. This is a very delicate and difficult matter.

It is not intended here to maintain that the solution of the problem of federal-state-local relations is the use of equalizing grants-in-aid. What is maintained is that there is no one solution to the problem of intergovernmental fiscal relations but that rather there are many approaches and that the prospects in the relatively near future are that all of them will be utilized to some extent. In the fields of education, relief, and social security, it appears likely that equalizing grants will develop in importance, because the conditions that point to such grants as a logical approach are present in strong degree.

BIBLIOGRAPHICAL NOTE

Study of public expenditures, as previously stated, involves in the first instance a consideration of the proper place of the state in the scheme of things. In addition to the works cited on this subject the reader may wish to consult Friedrich A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944); Herman Finer, *The Road to Reaction* (Boston: Little, Brown & Company, 1946); Walter Lippmann, *The Good Society* (Boston: Little, Brown & Company, 1937). For other general aspects of public expenditures two of the sources from which selections were made for the foregoing chapter can be recommended; these are: Harvey W. Peck, *Taxation and Welfare,* and Harold W. Guest, *Public Expenditures.* The article by A. A. Friedrich entitled "Veterans" and that by Gerhard Colm entitled "War Finance" in the *Encyclopaedia of the Social Sciences* can be recommended for reading on postwar military expenditures. On expenditures for highways and other public works, Charles Dearing's *American Highway Policy* (Washington, D.C.: Brookings Institution, 1942) and Arthur D. Gayer's *Public Works in Prosperity and Depression* (New York: National Bureau of Economic Research, 1935) should be mentioned. Further reference to J. M. Clark's study is recommended. In the field of educational finance the studies of the Advisory Committee on Education, particularly one by Clarence Heer, *Federal Aid and the Tax Problem* (Staff Study No. 4, U.S. Government Printing Office, 1939) should prove helpful. Concerning welfare expenditures, the National Resources Planning Board's study, *Security, Work, and Relief Policies,* is authoritative and comprehensive.

CHAPTER 11

PUBLIC DEBTS

AS THE federal debt rose to a new all-time high at the close of World War II, interest in public-debt economics and in intelligent debt management mounted accordingly. Good advice to young people has always featured the proposition that it is best to avoid getting into debt, but once there, to get out as soon as possible. From an early time, many have held that this advice also holds good for government. Others, however, particularly in recent years, have held that the public debt fills useful purposes, of which one is that it can put money and purchasing power into circulation during depression periods. Those who have lost their inhibitions in advocating the free use of borrowing insist that a sovereign government differs radically from an individual. When the former borrows internally, it creates an asset as well as a liability; and some governments, unlike individuals, can control the total money supply. This debate still continues, and some of it is reproduced in this chapter.

Debt management is a problem not only in public finance but also in monetary and banking economics. For better or worse, governments dispose of huge quantities of securities during wars by selling them to banks. In the postwar period, when banks begin to lend for purposes of civilian production and trade, a tendency may develop for interest rates to rise. Should the government seek to avoid this in order to save itself the extra cost involved in higher debt-carrying charges (after refinancing) and in order to prevent the longer issues from depreciating in value? If the government securities held by banks increase the latter's power to lend (by increasing reserves), should the government seek a tighter control of private credit (through more severe reserve requirements)? What about checking inflation by retiring bank loans and refinancing through securities sold to non-bank savers? And so forth.

It may be profitable, too, to re-examine the methods of war finance, seeking ways and means of avoiding inflationary pressure by avoiding its introduction.

The public-debt problem for state and local governments is a funda-

mentally different one. These units, like individuals, lack monetary powers. On the other hand, they do have problems in controlling the amount and the form of debt and in the many other intergovernmental relations that arise in this field.

International borrowing also has assumed large proportions. International credit may be public, or private, or mixed. In any event, it is heavily involved with problems of international trade and with the politics that attend economic penetration of one nation by another. The advice, "neither a borrower nor a lender be," may hold good for nations in their relations with each other; but lending relieves a country with surplus capital (oversaving) and supplies undeveloped nations with the wherewithal to industrialize.

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Early Views Concerning Public Indebtedness

MOST of the early writers on public finance were unreceptive to the idea of public credit. Representative of this writing is the following from Adam Smith: *

The public funds of the different indebted nations of Europe, particularly those of England, have by one author been represented as the accumulation of a great capital superadded to the other capital of the country, by means of which its trade is extended, its manufactures multiplied, and its lands cultivated and improved much beyond what they could have been by means of that other capital only. He does not consider that the capital which the first creditors of the public advanced to government, was, from the moment in which they advanced it, a certain portion of the annual produce turned away from serving in the function of a capital to serve in that of a revenue; from maintaining productive laborers to maintain unproductive ones, and to be spent and wasted, generally in the course of the year, without even the hope of any future reproduction. In return for the capital which they advanced they obtained, indeed, an annuity in the public funds in most cases of more than equal value. This annuity, no doubt, replaced to them their capital, and enabled them to carry on their trade and business to

* *Wealth of Nations,* Book V, Chap. 3.

the same or perhaps to a greater extent than before; that is, they were enabled either to borrow of other people a new capital upon the credit of this annuity, or by selling it to get from other people a new capital of their own equal or superior to that which they had advanced to government. This new capital, however, which they in this manner either bought or borrowed of other people, must have existed in the country before, and must have been employed, as all capitals are, in maintaining productive labor. When it came into the hands of those who had advanced their money to government, though it was in some respects a new capital to them, it was not so to the country, but was only a capital withdrawn from certain employments in order to be turned toward others. Though it replaced to them what they had advanced to government, it did not replace it to the country. Had they not advanced this capital to government, there would have been in the country two capitals, two portions of the annual produce, instead of one, employed in maintaining productive labor.

When for defraying the expense of government a revenue is raised within the year from the produce of free or unmortgaged taxes, a certain portion of the revenue of private people is only turned away from maintaining one species of unproductive labor towards maintaining another. Some part of what they pay in those taxes might no doubt have been accumulated into capital, and consequently employed in maintaining productive labor; but the greater part would probably have been spent and consequently employed in maintaining unproductive labor. The public expense, however, when defrayed in this manner, no doubt hinders more or less the further accumulation of new capital; but it does not necessarily occasion the destruction of any actually existing capital.

When the public expense is defrayed by funding, it is defrayed by the annual destruction of some capital which had before existed in the country; by the perversion of some portion of the annual produce which had before been destined for the maintenance of productive labor towards that of unproductive labor. As in this case, however, the taxes are lighter than they would have been had a revenue sufficient for defraying the same expense been raised within the year, the private revenue of individuals is necessarily less burdened, and consequently their ability to save and accumulate some part of that revenue into capital is a good deal less impaired. If the method of funding destroys more old capital, it at the same time hinders less the accumulation or acquisition of new capital than that of defraying the public expense by a revenue raised within the year. Under the system of funding, the frugality and industry of private people can more easily repair the breaches which the waste and extravagance of government may occasionally make in the general capital of the society.

It is only during the continuance of war, however, that the system of funding has this advantage over the other system. Were the expense of war to be defrayed always by a revenue raised within the year, the taxes from which that extraordinary revenue was drawn would last no longer than the war. The ability of private people to accumulate, though less during the war, would have been greater during the peace than under

the system of funding. War would not necessarily have occasioned the destruction of any old capitals, and peace would have occasioned the accumulation of many more new. Wars would in general be more speedily concluded, and less wantonly undertaken. The people feeling, during the continuance of the war, the complete burden of it, would soon grow weary of it, and government, in order to humour them, would not be under the necessity of carrying it on longer than it was necessary to do so. The foresight of the heavy and unavoidable burdens of war would hinder the people from wantonly calling for it when there was no real or solid interest to fight for. The seasons during which the ability of private people to accumulate was somewhat impaired would occur more rarely, and be of shorter continuance. Those, on the contrary, during which the ability was in the highest vigour would be of much longer duration than they can well be under the system of funding.

When funding, besides, has made a certain progress, the multiplication of taxes which it brings along with it sometimes impairs as much the ability of private people to accumulate even in time of peace, as the other system would in time of war. The peace revenue of Great Britain amounts at present to more than ten millions a year. If free and unmortgaged, it might be sufficient, with proper management and without contracting a shilling of new debt, to carry on the most vigorous war. The private revenue of the inhabitants of Great Britain is at present as much incumbered in time of peace, their ability to accumulate is as much impaired as it would have been in the time of the most expensive war had the pernicious system of funding never been adopted.

In the payment of the interest of the public debt, it has been said, it is the right hand which pays the left. The money does not go out of the country. It is only a part of the revenue of one set of the inhabitants which is transferred to another, and the nation is not a farthing the poorer. This apology is founded altogether in the sophistry of the mercantile system, and after the long examination which I have already bestowed upon that system, it may perhaps be unnecessary to say anything further about it. It supposes, besides, that the whole public debt is owing to the inhabitants of the country, which happens not to be true; the Dutch, as well as several other foreign nations, having a very considerable share in our public funds. But though the whole debt were owing to the inhabitants of the country, it would not upon that account be less pernicious.

Land and capital stock are the two original sources of all revenue both private and public. Capital stock pays the wages of productive labor, whether employed in agriculture, manufactures, or commerce. The management of those two original sources of revenue belongs to two different sets of people; the proprietors of land, and the owners or employers of capital stock.

The proprietor of land is interested for the sake of his own revenue to keep his estate in as good condition as he can, by building and repairing his tenants' houses, by making and maintaining the necessary drains and enclosures, and all those other expensive improvements which it properly belongs to the landlord to make and maintain. But

by different land-taxes the revenue of the landlord may be so much diminished, and by different duties upon the necessaries and conveniences of life that diminished revenue may be rendered of so little real value, that he may find himself altogether unable to make or maintain those expensive improvements. When the landlord, however, ceases to do his part, it is altogether impossible that the tenant should continue to do his. As the distress of the landlord increases, the agriculture of the country must necessarily decline.

When, by different taxes upon the necessaries and conveniences of life, the owners and employers of capital stock find that whatever revenue they derive from it will not, in a particular country, purchase the same quantity of those necessaries and conveniences which an equal revenue would in almost any other, they will be disposed to remove to some other. And when, in order to raise those taxes, all or the greater part of merchants and manufacturers, that is, all or the greater part of the employers of great capitals, come to be continually exposed to the mortifying and vexatious visits of the tax-gatherers, this disposition to remove will soon be changed into an actual removal. The industry of the country will necessarily fall with the removal of the capital which supported it, and the ruin of trade and manufactures will follow the declension of agriculture.

To transfer from the owners of those two great sources of revenue, land and capital stock, from the persons immediately interested in the good condition of every particular portion of land, and in the good management of every particular portion of capital stock, to another set of persons (the creditors of the public, who have no such particular interest), the greater part of the revenue arising from either must, in the long-run, occasion both the neglect of land, and the waste or removal of capital stock. A creditor of the public has no doubt a general interest in the prosperity of the agriculture, manufactures, and commerce of the country, and consequently in the good condition of its lands, and in the good management of its capital stock. Should there be any general failure or declension in any of these things, the produce of the different taxes might no longer be sufficient to pay him the annuity or interest which is due to him. But a creditor of the public, considered merely as such, has no interest in the good condition of any particular portion of land, or in the good management of any particular portion of capital stock. As a creditor of the public he has no knowledge of any such particular portion. He has no inspection of it. He can have no care about it. Its ruin may in some cases be unknown to him, and cannot directly affect him.

The practice of funding has gradually enfeebled every state which has adopted it. The Italian republics seem to have begun it. Genoa and Venice, the only two remaining which can pretend to an independent existence, have both been enfeebled by it. Spain seems to have learned the practice from the Italian republics, and (its taxes being probably less judicious than theirs) it has, in proportion to its natural strength, been still more enfeebled. The debts of Spain are of very old standing. It was deeply in debt before the end of the sixteenth century, about a hundred years before England owed a

shilling. France, notwithstanding all its natural resources, languishes under an oppressive load of the same kind. The republic of the United Provinces is as much enfeebled by its debts as either Genoa or Venice. Is it likely that in Great Britain alone a practice, which has brought either weakness or desolation into every other country, should prove altogether innocent?

The system of taxation established in those different countries, it may be said, is inferior to that of England. I believe it is so. But it ought to be remembered, that when the wisest government has exhausted all the proper subjects of taxation, it must, in cases of urgent necessity, have recourse to improper ones. The wise republic of Holland has upon some occasions been obliged to have recourse to taxes as inconvenient as the greater part of those of Spain. Another war begun before any considerable liberation of the public revenue had been brought about, and growing in its progress as expensive as the last war, may, from irresistible necessity, render the British system of taxation as oppressive as that of Holland, or even as that of Spain. To the honor of our present system of taxation, indeed, it has hitherto given so little embarrassment to industry, that during the course even of the most expensive wars, the frugality and good conduct of individuals seem to have been able, by saving and accumulation, to repair all the breaches which the waste and extravagance of government had made in the general capital of the society. At the conclusion of the late war, the most expensive that Great Britain ever waged, her agriculture was as flourishing, her manufactures as numerous and as fully employed, and her commerce as extensive as they had ever been before. The capital, therefore, which supported all those different branches of industry must have been equal to what it had ever been before. Since the peace, agriculture has been still further improved, the rents of houses have risen in every town and village of the country—a proof of the increasing wealth and revenue of the people; and the annual amount of the greater part of the old taxes, of the principal branches of the excise and customs in particular, has been continually increasing—an equally clear proof of an increasing consumption, and consequently of an increasing produce which could alone support that consumption. Great Britain seems to support with ease a burden which, half a century ago, nobody believed her capable of supporting. Let us not, however, upon this account rashly conclude that she is capable of supporting any burden, nor even be too confident that she could support, without great distress, a burden a little greater than what has already been laid upon her.

When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by a bankruptcy; sometimes by an avowed one, but always by a real one, though frequently by a pretended payment.

In 1767, eight years before Adam Smith's *Wealth of Nations,* Sir James Steuart discussed the subject of public debt in his *Principles of Political Economy*. He was one of the first to propound the view (which has many modern adherents) that public debt should function as the balance wheel of the economy. The selection here presented is from a recent exposition of Steuart's views on this subject by Walter F. Stettner.*

Public vs. *Private Debt.* Steuart's approach to the problem of public borrowing is indicated by his preference for the term public "credit" rather than public "debt." This follows from his view that credit is an asset to the community—one of the tools of progress. He sees two important differences between public and private credit. One is in the person of the debtor. Under a private debt contract the person who incurs the debt is himself responsible to the creditors for its repayment. On the other hand, those who contract an obligation in the name of the state are not themselves responsible for it. "Hence it happens, that private people are commonly more anxious about paying their debts than statesmen are who administer for the public." [1] Another important difference is their effects on the prosperity of the debtor:

> The interest of a private debtor is simple and uncompounded; that of a state is so complex, that the debts they owe, *when due to citizens,* are, on the whole, rather advantageous than burdensome: they produce a new branch of circulation among individuals, but take nothing from the general patrimony.[2]

Public debts play a constructive role in the economy. Internal public debts do not burden the economy, waste resources, or make the economy poorer. On the contrary, they are advantageous, and serve to increase productivity. ". . . the country is neither poorer or richer, when considered in a cumulative view, than if the same sum had been lent to private people at home." [3] Rather, ". . . the effect of public borrowing, or national debt, is to augment the permanent income of the country, out of stagnating money, and balances of trade." [4]

Steuart was aware that this concept of public credit was quite new. Fifty years earlier, when Davenant wrote on the subject, these effects of public credit were not yet recognized. It was considered closely akin to private credit, and both Parliament and the people, on the whole, looked upon it with suspicion. The creditors were viewed as enemies of the public, and lending to the Government was feared as an opportunity for personal aggrandizement.[5] The relation be-

[1] Steuart, *op. cit.,* Vol. II, p. 625.

[2] *Loc. cit.*

[3] *Ibid.,* p. 449.

[4] *Ibid.,* p. 451.

[5] *Ibid.,* p. 357: "Men, at that time, had a terror upon them in contracting debts for the public: they considered the nation as they would a private man, whose interest is one, uncompounded, and relative to himself alone: in this light, creditors appeared as formidable as enemies; they were looked upon by ministers as such; and this general opinion on one side, contributed, no doubt,

* Reprinted by permission from Walter F. Stettner, "Sir James Steuart on the Public Debt," *The Quarterly Journal of Economics,* LIX (Cambridge: Harvard University Press, May 1945), 454–460.

tween the use of public credit and economic progress had not yet been realized.

Public Debt and Circulation. The public credit, according to Steuart, is an important instrument in promoting the development of industry and trade in a country, but it can perform this function only if the economy is well supplied with a circulating medium. Economic development needs as its vehicle an adequate and sufficient amount of circulation to implement the demand for consumption goods and make it possible to dispose of the products of industry.

Metallic circulation, however, cannot keep pace with the increased requirements of the economy; it must be supplemented by fiduciary circulation. This leads to the establishment of credit. The increased liquidity introduced by government securities makes it possible to "melt down private property." Individuals can now borrow upon their property, traders on their stock in trade, and holders of government bonds on government paper.[6] In this respect public credit has the same function as private credit. It makes the economy more liquid and provides funds for industry and trade. Public securities offer a ready investment for people who have available funds which they would not otherwise use.

The beneficial influence of such an investment opportunity was admitted even by Hume, who pointed out that the merchants who can invest part of their funds in government issues are thereby in a position to trade upon lower profit, reducing the price of the commodities and encouraging greater consumption. But he felt that the unfavorable effects of public debts on the economy were much greater, and adds, "You will find no comparison between the ill and the good which result from them." [7]

Steuart makes it clear that investment in government securities does not take the place of other investment opportunities, but is a net addition to total investment. In a way it merely supplements private investment.[8]

Public Credit as the Balance Wheel. Steuart recognizes that public borrowing must be adjusted to the conditions of trade at the particular time. Public borrowing is inappropriate as long as "circulation is full," because then it would only raise the rate of interest and have undesirable consequences for commerce. On the other hand, when circulation is stagnating in one part of the economy and there is unemployment and a slackening of trade and industry, the state should absorb this excess and through its expenditures throw it into new channels of circu-

to make the monied people less interested in the distress of government, and more ready to lay hold of every opportunity of improving such occasions, for their own advantage."

[6] *Ibid.*, Vol. I, p. 366: "Those nations, therefore, who only circulate their metals, confine industry to the proportion of the mass of them. Those who would circulate their lands, their houses, their manufactures, nay their personal service, even their hours, might produce an encouragement for industry far beyond what could be done by metals only. And this may be done, when the progress of industry demands a circulation beyond their power."

[7] Hume, "Of Public Credit," p. 7.

[8] Steuart, *op. cit.*, Vol. II, p. 450: "We have said that loans are filled by money stagnating, which the owner desires to realize: if he cannot do better, he lends it to the government; if he can do better, he will not lend it."

lation.[9] Thus the use of public credit is conceived as the balance wheel in the economy. It keeps resources fully employed, and prevents stagnation in any part of the economy from having an adverse effect elsewhere. In addition public credit is a necessary instrument of war finance.[10]

This balancing function of public credit, however, cannot be achieved without the active intervention and guidance of the statesman. As conditions seem to require, he should discourage luxury and prodigality, or encourage production and consumption.[11] In general, his actions should be directed toward an expansion of production and consumption, rather than having a restrictive effect.[12]

In Steuart's view the harmony between the public and private interest assumed by the classical economists cannot be taken for granted. The self-interest of individuals can be relied upon for the management of their own affairs; it does not, however, necessarily ensure the welfare of the public. The function of the statesman is therefore to safeguard the public interest.

Comparison with Taxes. According to Steuart taxes perform a function similar to that of public credit, making people more industrious and enriching the nation. "When they are properly levied, they only abridge unnecessary private expence: when they are properly applied by the state, they advance improvement every where." [13] The industrious classes do not bear the burden of increased taxation, which falls rather upon the idle rich in proportion to their luxury only. On the other hand, the increased revenue in the hands of the state makes possible expenditures which stimulate trade and industry and provide employment.[14] Thus the real fund from which taxes are paid is that produced by the additional activity and industry which they bring about.[15]

For taxes to have this effect, however, the monetary circulation of the country must be increased to the same extent as the taxes; [16] otherwise the economic flow and the industry of the country will be interrupted. In earlier times, taxation was of little use to the Government and a considerable burden on the people, simply because the volume of monetary circulation was inadequate for maintaining the level of economic activity, despite the additional impositions. Banking facilities were not available for turning "the value in the hands of the people" into money. With ade-

[9] *Ibid.*, p. 449: ". . . we consider it as in a state of stagnation; but being lent to government, it is thrown into a new channel of circulation."

[10] *Ibid.*, p. 371, note: "Nothing however is more certain than that in time of war, far greater sums are required than any people can pay, without contracting debts."

[11] *Ibid.*, Vol. I, p. 375: "He ought at all times to maintain a just proportion between the produce of industry, and the quantity of circulating equivalent, in the hands of his subjects, for the purchase of it; that, by a steady and judicious administration, he may have it in his power at all times, either to check prodigality and hurtful luxury, or to extend industry and domestic consumption, according as the circumstances of his people shall require the one or the other corrective, to be applied to the natural bent and spirit of the times."

[12] *Ibid.*, pp. 490–491.

[13] *Ibid.*, Vol. II, p. 640.

[14] *Ibid.*, p. 554.

[15] *Ibid.*, p. 555: "This is the fund out of which the greatest part of taxes is paid; it is a fund created by the industrious Britons, which I hope will increase for many centuries, tho' taxes should increase in proportion."

[16] *Ibid.*, p. 366.

quate monetary mechanisms, however, and when properly imposed, taxes do not burden the economy. They "resemble the expence laid out upon new establishments for improvement; because in their consequences they augment the prosperity and ease of the whole people, not by being levied, but being properly applied." [17]

Thus it is clear that Steuart's concept of the impact of government finance on the economy differs basically from that of the classical writers. The latter pictured an economy burdened and oppressed by public debts and taxes, which dissipated resources, destroyed existing capital and prevented, or at least retarded, capital accumulation. In addition, they argued that the public debt gave rise to an idle class of stockholders living on their revenues and constituting a drag on the industrious groups in the economy. Steuart, on the other hand, looks upon debts and taxes as important instruments for promoting thrift and industry and leading the economy to ever rising levels of production, consumption, and income. His whole concept of the economic process is much more dynamic, and emphasizes change and growth as compared with the more static orthodox approach of his time.

Social Effects. For a correct appraisal of the role and impact of public debts it is not sufficient to discuss merely their effect on the economy; their influence on the social structure must also be taken into consideration. Actually, the use of public credit has usually been rejected on the ground that it upsets and changes the social structure in a direction considered undesirable by the writer.

[17] *Ibid.*, p. 643.

A particularly clear instance of this is found in Hume's violent rejection of the public debt on the ground that it would disrupt the existing social structure, which he claimed conformed to the natural order of things. The public debt would create a class of stockholders who would draw "almost all the rent of the land and houses, besides the produce of all the customs and excises," and would "sink into the lethargy of a stupid and pampered luxury, without spirit, ambition, or enjoyment. Adieu to all ideas of nobility, gentry, and family." [18] This stock capital conveys "no hereditary authority or credit to the possessors" and thus "the several ranks of men, which form a kind of independent magistracy in a state, instituted by the hand of nature, are entirely lost." [19] The weakened economic position of the landed gentry would also weaken their political prestige and influence and would result in despotism.[20] Similarly, social stigma is put on the creditors as an idle class making no "productive" contribution to the economy.

There can be no doubt that the growth of the public debt in Great Britain during the eighteenth century had a profound social influence. It created a new form of wealth and security in addition to land—the ownership of government bonds. And it promoted thrift and savings by providing an investment which was more readily accessible than the purchase of land; through the expansion of public credit a growing part of the population became property

[18] Hume, *op. cit.*, p. 10.

[19] *Loc. cit.*

[20] *Ibid.*, p. 11: "And the middle power between King and people being totally removed, a grievous despotism must infallibly prevail."

holders. It developed their interest in the affairs of the state, and a spirit of community, and made for political stability. Government thus became no longer the privilege of a few, but rather the interest of many.

Steuart is fully aware of these effects of public credit and looks upon them favorably. He states that the increase of public debts creates an enormous fund of property in the economy,[21] and produces a "vibration in the balance of domestic wealth" creating a monied interest which grows in proportion as debts increase. He approves the influence of greater liquidity in making fortunes more equal.[22] It is true that with the swelling of public debts the creditors' position in the economy becomes stronger, but a more important effect is to break down the barriers between various social groups and promote greater understanding and social flexibility.[23]

Repayment. Steuart does not feel that extensive debt repayment is always necessary or desirable. The proper policy with respect to debt repayment depends upon the existing circumstances. This is in marked contrast to the classical writers who postulated complete debt repayment as a first requirement of sound debt management. His position is not surprising, in view of his concern over the effect of fiscal measures on circulation and general economic conditions. While debt repayment in certain situations was desirable, he felt that at other times it would remove an important source of investment and have a depressing influence on the economy.

[21] *Op. cit.*, Vol. II, p. 446.

[22] *Ibid.*, Vol. I, p. 367: "The use of symbolical money is no more than to enable those who have effects . . . to give an adequate circulating equivalent for the services they demand, . . . it is a method of melting down, as it were, the very causes of inequality, and of rendering fortunes equal."

[23] *Ibid.*, Vol. II, p. 446: "The allurement of acquiring land-property is very great, no doubt, especially to monied men. The ease and affluence of those, on the other hand, who have their capitals in their pocket-books, is very attracting to the eyes of many landlords, especially at a time when they are paying the heavy taxes laid upon their possessions."

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Modern Views of the Public Debt

THIS discussion followed papers presented by Alvin Hansen and Fred R. Fairchild at the 1943 National Tax Association Conference.* Unfortunately, space does not permit a reproduction of the papers themselves. The discussion discloses the conflict of opinion there expressed and also introduces additional opinions.

* *1943 Proceedings*, pp. 284–292; 295–299.

Chairman Shoup: The next discussant will be Henry Bloch, Instructor in Economics at the University of Chicago.

Henry S. Bloch: Ladies and Gentlemen: I, too, am opposed to the present practices of public borrowing. I, too, am worried about the postwar consequences of our war borrowing. In fact, I am much more concerned about the public borrowing of today than about the debt of the past or the debt of the future. My present worry stems from my fear of inflation, rather than from a concern about the absolute size of the public debt. However, if I were afraid of the absolute size of the public debt as Professor Fairchild is, I still would start right now advocating remedies to stop the further increase of the public debt.

There is perhaps a "new school" or a "new philosophy" of the public debt, yet there is also a new philosophy of the "runaround." The new philosophy of the runaround consists in lamenting about the ever-increasing public debt, but to do nothing about the only means which can stop this increase, to wit: a strong and adequate tax program coupled with strong and vigorous price control policies. This approach reminds me of my mother. She often tells me that I am getting too fat and then offers me chocolate cream pie for dessert. If all the people in this country who moan and groan about the size of the public debt would rally strongly behind the Treasury with its limited proposals for increased taxation, or better still, if they would support the more vigorous proposals of men like Professor Hansen and Professor Leland, this nation would make greater progress towards sound financial policy. I, therefore, propose that Professors Fairchild and Lutz and all the other opponents of our so-called new philosophy of the public debt join us in our present endeavor towards increased taxation today in order to alleviate the present inflation which *we* fear as well as *their* private fears of the gigantic size of the debt of tomorrow. This much by way of general introduction.

Maximum Tax Limits

If you will allow me to do so, I shall now delve into recent history, and by this I mean previous speeches of Professor Fairchild. Since Professor Fairchild is so much concerned with the size of the debt, it is, of course, very much worthwhile to look into his proposals in re taxation. Today Professor Fairchild said that, in peacetime, we would not be able to stand much more than twenty-five per cent of the national income in taxation, but that this percentage was quite bearable, in fact, recommendable. In 1940, at the National Tax Conference in New York City, Professor Fairchild said: "Competent authorities are of the opinion, that the utmost that the national government could raise in taxation under present economic conditions is about six and a half billion dollars a year." [1] He added, that "there is, of course, the possibility that war conditions might somewhat raise taxable capacity." [2] This possibility he called, however, a "dubious prospect." [3]

Competent authorities notwithstanding, budgetary receipts totalled $8,269,000,000 in fiscal 1941, $13,-

[1] *1940 Proceedings*, National Tax Conference, p. 78.
[2] *Op. cit.*
[3] *Ibid.*

668,000,000 in fiscal 1942 and $23,-385,000,000 in fiscal year 1943.[4] In fiscal year 1944 they may, according to Professor Fairchild's own statement of today, exceed 40 billion dollars.

Considering the percentage of the national income which can be paid in taxes, Professor Fairchild took in 1940 a figure representing together with local taxes approximately twenty per cent as the maximum or the near-maximum which the nation could stand in wartime. Today, he advocates 25 per cent as the maximum for peacetime conditions.

I mentioned all these inconsistencies, not in order to show disrespect to Professor Fairchild, but rather to point out that even great authorities like the professor himself cannot accurately determine for times to come a certain percentage of our national income which we can pay in taxes or in any other way to our national government. There are only relatives, there are no absolute ratios. Flexible thinking, and not only flexible tax policy, is needed. Quotes from the past can, of course, not only be used to embarrass the men on the other side of the fence, but also my own friends and myself.

Let me emphasize, however, that other nations are paying much higher percentages of their national incomes and of their total expenditures in taxation than we do and that they achieve a higher degree of inflation control. Outstanding among such countries are Australia, New Zealand, Canada and England. Dr. Musgrave will show tomorrow some comparative data to substantiate this argument. The interesting angle is, that the leadership of British Australian and New Zealand finances is to a certain degree committed to the so-called new philosophy of the public debt and just because of that they do a better job in taxation than the opponents ever achieved.

Professor Fairchild himself, who has often attacked advocates of "perpetual debt," joins these advocates today by saying that a federal debt of 280 billion dollars should be retired at the rate of 2 billion dollars a year, a rate which would bring about total liquidation after 140 years or more.

Professor Hansen, who does not need me to defend him, has already explained that deficit financing is not advocated for its own sake, nor is it advocated at all times. Professor McC. Wright in a recent article in *The American Economic Review,* directed against Moulton's pamphlet, has demonstrated how advocates of the "new philosophy" have been accused of professing things they never professed.

As McC. Wright put it: "He (Moulton) never grasps that Hansen is arguing for a high propensity to consume or a low one for its own sake but only with reference to the conditions obtaining at some one point of time."[5]

Debt Policy

Professor Fairchild referred to an article in *Fortune* magazine which seemed unconcerned as to whether the budget was ever balanced. My own interpretation is that in this article it was stated that the budget never needs exact balancing and practically never is exactly balanced.

[4] Bulletin of the Treasury Department, October 1943, p. 15.

[5] D. McC. Wright, "Moulton's The New Philosophy of the Public Debt," *The American Economic Review,* XXXIII, No. 3 (September 1943), p. 579.

It may be both over- and underbalanced. To illustrate the complications of overbalancing I quote Henry C. Adams who wrote in 1888: "we must . . . unless we are willing to approve of recklessness and extravagance in the continued payment of the debt look in some other direction for relief from surplus revenue." [6]

Obviously such a situation will not return for many years to come. The interest burden alone will amount to more than three billion dollars a year. There is hardly anyone who is not disturbed to some extent by the prospect of future distribution problems created by a public debt held to a large extent by commercial banks and other commercial institutions.

The attitude of the "new philoso phers" towards borrowing is primarily determined by the ratio of the flow of money payments to the flow of available consumers' goods. If the flow of money payments increases at a faster rate than the flow of consumers' goods inflationary borrowing is definitely undesirable and large-scale taxation is necessary to withdraw excess buying power. This is the reason why we insist today on increased taxation. I herewith challenge the advocates of so-called "sound" financing to join us in serious advancement of proposals designed to replace inflationary borrowing by taxation and noninflationary borrowing.

Professor Fairchild did not refer to that distinction between inflationary and noninflationary borrowing which plays such an important role in modern financing policy. Dr. Langum has pointed it out quite clearly, yet I wish to specify it once more: Noninflationary borrowing means borrowing of money which would otherwise have been spent by the lender. It should be understood that inflationary borrowing is not only borrowing from the commercial banks, but also borrowing from corporations which invest their excess balances in government bonds. Noninflationary borrowing is primarily borrowing from the lower income classes.

Prevention of Inflation

Only through a forced savings program shall we be able to make borrowing a noninflationary instrument. Only through forced savings can the government be enabled to determine in advance the redemption conditions of the public debt. This will be explained in greater detail by Professor Simeon E. Leland.

In order to secure additional tax revenues and in order to improve the social welfare of the people I furthermore recommend an increased social security program. I believe that the immediate introduction of measures as they were advocated in the Wagner-Dingell bill would have the following effects:

1. Withdraw excess buying power at present and therefore help in the fight against inflation.

2. Force the people to build up their own reserves when they can afford it. Trade them future security for present increased work.

3. Provide the government with reserves for future liabilities which will then be met out of available funds instead of additional deficit financing. It may be noted that these future disbursements will have all the good purchasing power creating

[6] Henry C. Adams, "Surplus Financiering," *The National Revenues*, p. 48. (A collection of papers by American economists, edited by Albert Shaw, Chicago, 1888.)

effects which straight deficit financing would have, but that administrative and other complications might be reduced.

Since it is likely that large cash demands may be made upon the Treasury at some future time and that large-scale repayments of war bonds at the inopportune moment may create inflationary developments, I recommend a strong development of a flexible and all-inclusive federal income tax. I still remember the days when we spoke at these meetings of the property tax as the largest single American tax. Today the much more refined personal income tax, based on the ability-to-pay principle, has more than taken the place of the property tax. It has developed into an instrument of fiscal policy which, if properly handled, can be used as a major brake against inflation. In a period of depression, it will be easy for a courageous Congress to increase exemptions and allow more deductions, both methods which are more useful to the lowest income groups than a change in rates. In order to fight inflation today, however, it will be necessary to raise the rates and stuff the loopholes. For that, legislative courage is needed.

Conclusion

In conclusion, I should attempt to make a synthesis. This, however, is impossible. It is impossible because a difference in moral judgment is involved. One side is primarily concerned with balancing the budget. The other side is concerned with social welfare. If a balanced budget is to be our prime consideration, it will not be possible to give adequate adjustment possibilities to the ex-service men, the veterans of this war. If social welfare is the prime consideration, demobilization plans will not be stopped because of fiscal traditions which have no real economic significance.

Today, almost all men are inclined to breastbeating and to calling themselves sound and good. This makes it even more difficult to define a stand. Let me say that in my own opinion, no economics is good economics if it harms the poor man. This means, that we must build up a terrific resistance against those pressure groups who try to teach us a different ideology.

CHAIRMAN SHOUP: In view of the lateness of the hour, I suggest we proceed directly to questions and discussions from the floor with a request to Professor Hansen and Professor Fairchild to give us a little résumé at the end, if that is suitable from their point of view.

Criticism of Hansen Philosophy

HARLEY L. LUTZ (New Jersey): My name was taken in vain a moment ago but I do not rise simply for that purpose. Mr. Bloch seemed to imply that I was opposed to taxation. I am not sure that he is aware that I was advocating the pay-as-you-go system of taxation long before Mr. Ruml made it popular. I am not sure that he is aware of the extent to which I am for levying taxes today. Our difference probably would be in the kind of taxes which we would levy. For example, if he will go along with me on a good stiff sales tax, I think we might get somewhere in meeting the needs of the Treasury instead of the cock-eyed program which the Treasury itself proposed.

The Secretary of the Treasury himself pointed out that 81 per cent of the total income payments to be

made in 1944 will be made in amounts under $5,000. How are you going to stiffen the income tax to reach that kind of income payments satisfactorily? I maintain that a good stiff sales tax is the only way to do it, and when it comes to the social security tax program, I suppose Mr. Bloch referred to the rates proposed in the Wagner-Murray bill. Those rates would collect six per cent from all income payments up to $3,000, without any deduction for marital status, the number of kids you have, the amount of mortgage on your house, or anything else.

Let's take the fellow who they always use when they oppose the sales tax, the guy with $500 a year. I maintain he is only a statistical abstraction in these days, that there aren't any such; but supposing there were. A six per cent social security tax for something that he may get in the remote and beautiful future that we are going to have after the war would mean $30 a year. After this guy pays his rent, and a few other items that won't be subject to a retail sales tax on commodities, he wouldn't pay any more than $30 a year. In one case he is paying for something that he may get at some happy distant day, and in the other case he is helping to prevent an inflation that will destroy the value of his social security payment if and when he gets it.

I would like to turn to Professor Hansen, and I might say by way of introduction that I have read a good deal of functional finance material, and it always reminds me of what someone said about the science of economics. He said, "You can boil it all down to one short sentence: There is no free lunch." For 10 years we have been living in a society in which everybody has been taught that there is a free lunch for all, free tickets to the ball game, and a free ride to the ball park.

Professor Hansen wants a fiscal policy which will give us a stable and developmental economy. Well, I take it that by that he means that by some kind of screwy manipulation of debt, taxes and expenditures we can prevent depressions. Of course, the compensatory aspect of that is that when you start to ask what exactly is it you are going to compensate for, you will find that it will boil down to this: It means that when you start spending in a depression, you compensate against the rigidity of wages. Our housing subsidies are subsidies really to the frightful and exorbitant and extremely rigid rates of wages in the building trades, and if you had anything like proper flexibility in the building trades you wouldn't have to subsidize housing in order that the little fellow might live in those houses. And so it is in the depression. Until you can get flexible wage rates in a depression you will always have to subsidize them, because if a guy won't work for less than $1.50 an hour he has to have relief from the government.

You know of course that the underlying theme of all of this functional finance doctrine is inflation. Professor Hansen himself pointed out and emphasized the fact that Dr. Moulton agreed with him that debt must be increased during the depression. It was later conceded that we probably would not pay off all of that debt during the ensuing boom. The chances are we will never pay off any of it, because there will always be plenty of good reasons why we should do other things with the

money during the boom than to pay off the debt; so we go into the next depression with a still larger debt, and so on. As long as we can maintain the inflationary process, as long as we can kid ourselves that there is a free lunch and free tickets to the ball game, we can keep the economy afloat.

He pointed out further and emphasized, as he has in other writings, that one important reason for the public debt is to provide an income for the banks, insurance companies, and other institutions that are performing a useful service. If Roy Osgood will just plug his ears for a moment, I would like to say that if that is the best case you can make for public debt it is a mighty weak case. If we have to keep on paying taxes indefinitely at the rate you are supposed to pay them in order to provide an income for the banks and the insurance companies, and other institutions that are performing a useful service, then God help both the banks and the insurance companies and the taxpayers. It seems to me that that is one of the weakest arguments which you could possibly devise.

If a bank or an insurance company cannot perform a sufficiently useful service to the community so that the community in some way or other, through premiums, or through service charges or through other forms of payment for those services, will provide a revenue that will support the institution, then we had better get rid of the institution.

Then I come to the point of owing it to ourselves. Of course, it is true, if I own a bond I have an asset and all the rest of you people in paying the taxes will pay interest to me. But of course when you generalize that you find I am working for everybody else in the community. If I have $1,000 as assets and have $1,000 of liabilities, what is my net worth? I will give you two seconds to give me the answer to that. It is exactly zero.

When we do look at this thing as a matter of owing it to ourselves, then it is true you can call it assets or liabilities according to the way of looking, and you will find out that it washes out and it doesn't really enhance the economy in the slightest any more than the case I have mentioned.

Another point was this, that as long as the national income can be maintained at a high level, the debt will be no burden. If you follow the argument, you find that as a corollary, and as a consequence, whenever the national income begins to sag, then we must raise it again by pumping in some more debt, and then we get along for a while, and presently it sags some more and we pump in some more debt. We never have a chance to retire any of it because that is contrary to public policy, and the people wouldn't like it and the politicians would be bitter against it. So we keep on pumping in whenever it sags, and in that way we can maintain a national income of any desired level, so that the taxes on any amount of debt would be only a very small fraction of that income.

Did you ever hear of Johnny Fitch? You know, they laughed at him a century and a half ago. They said he was crazy. But he, poor soul, only believed in this one simple proposition, that there could be perpetual motion. Here we have a process of maintaining high national income by a continuous process of inflation, so that we can always keep the income

so high that we will never feel the taxes on the debt that we create to produce that income that is needed in order to enable us to pay the taxes on this mounting debt. If that isn't Johnny Fitch all over again I don't know where you will find him.

Adam Smith said, also about a century and a half ago—and I heard Mr. Bloch say that he and Professor Leland quoted Henry Carter Adams. I sometimes do. I don't know whether they go back far enough into history any more to quote Adam Smith or not, but Adam Smith said that there has never been a case in history of a large national debt being fully and honestly paid. He said sometimes they are frank enough to repudiate it, which is an honest confession that you don't want to or can't pay it. More often, he says, it is circuitous and dishonest way of devaluing the currency.

Whenever I read that passage in Adam Smith I am reminded of the story that Mark Twain told about the fellow who came to Rio de Janeiro. This fellow went into a restaurant with some of his friends and ordered a dinner, several courses, with wine with each course, cigars, and brandy after the dessert. When the proprietor came around presently he presented him with a bill for 180,000 milreis. This fellow nearly died. He pulled out his watch, his wallet, his traveler's checks, and his cuff-links. He laid them on the table, and bathed in perspiration and trembling all over he explained to the proprietor that that was all he had with him, he would send home for the rest of his assets, and he would pledge himself to work for the remainder of his life to pay this terrible bill of 180,000 milreis.

Well, the proprietor explained in due course that this bill for 180,000 milreis was after all only a bill for $8 United States currency.

I give you your choice. You can go on down the rosy path of functional finance, and some day you will be paying $180,000 for an $8 dinner, or maybe a $2 dinner, or maybe only a 50-cent dinner, but after all, it will be a 50-cent dinner, even though you pay 180,000 so-called smackers for it.

* * * *

Summary by Professor Hansen

PROFESSOR HANSEN: I think I will comment only on a few things, because otherwise I would be making a speech of two or three hours, and you have already been extremely patient.

I would like to say that I did not say banks could not get along without the interest from government bonds. They could, to be sure, charge service charges. What I did say is that the money that is paid to the banks is not thrown away for useless services, and that in fact, if we should wake up tomorrow by some magic and find that the bonds held by the banks had disappeared, and we said, "Ah, ha, that is wonderful, we don't have to pay interest any more on those bonds," we would in fact discover that we would have to cover the costs of the bank in some other manner. And that is all I said. I did not say the banks cannot or could not in other ways cover their costs.

Mr. Lutz had a little fun about the bond he owns, which he figured was really worth nothing because he paid taxes by and large covering the interest charges. I submit that the problem isn't quite as funny as that. It isn't quite as simple as that. I

think it is a fact that a widely distributed public debt can be described as a sort of national insurance system. It is an insurance system from which we all get benefits more or less in proportion to our income in terms of the interest received on the bonds we hold; not exactly, but more or less as the bonds are in fact distributed. It is an insurance system to which we are all paying premiums more or less in proportion to our income status.

But that is not the whole story. It may be that I am paying into that central pool as much as I take out, but I do hold a bond, Mr. Lutz notwithstanding, a bond that I can sell for $1,000 if it is a par value $1,000 bond, or I can go to the bank and borrow on it, and in case of distress I have something there that is of real genuine value in terms of security. So that it can be described as a kind of national insurance system, and it was just that that Winston Churchill referred to in the speech which I mentioned.

I would like to say a word about the history of the British public debt to which Professor Fairchild did not refer though he referred to some other countries. The alarm that he voiced that we at the end of this war will have reached exactly the amount of debt which we can stand was in fact stated 200 years before by Hume, the great British philosopher, and I suspect that it has passed down from Hume to other writers from whom Mr. Fairchild got his phrases.

Hume said in substance: "We have been witnessing in our time"—he said this in 1752—"and for some generations past an extraordinarily rapid increase in the public debt." That was so—an extraordinarily rapid increase in the public debt. "Now," he said, "this just can't continue. We just are on the edge of going bankrupt. It is true that we are really carrying it with comparative ease now, but we just can't go any further. I hesitate," he said, "a little bit to say exactly when we are going headlong into repudiation, because our fathers said exactly the same thing, and we didn't go off into repudiation; we didn't go bankrupt." So he hesitated a little bit. He would certainly have been surprised had he known in 1752 that in the next 65 years the public debt of England would increase ten-fold, and still there was no repudiation; they still didn't experience national bankruptcy.

The debt that England had at the end of the Napoleonic wars was in fact twice the British national income. I indicate that figure not to suggest that is the limit to which the debt can go, because I don't think it is, but just to show that that did happen at that time. That debt was in fact only to a very, very small percentage repaid during the 19th century. It was about the same order of magnitude in 1914 as at the end of the Napoleonic wars, and then it increased again enormously and was again twice the British national income as it had been in the Napoleonic wars. And when the Colwyn Committee reported on the effect of the national debt in England in the middle of the '20's, the conclusion was that Britain had a lot of very difficult problems confronting them, but the public debt was a negligible matter. That was the conclusion of the Colwyn Committee report.

Every generation should seek to manage its affairs in terms of the criteria that I indicate—and they must never be lost sight of—of eco-

nomic stability, and an expanding economy. Britain by and large did. At any rate there occurred neither violent inflation or deflation. Sir James Steuart, shortly after Hume, pointed out that the all-important reason why England with an enormous public debt nevertheless always had very sound public credit was that they paid much more attention to maintaining the value of their bonds than they did to talk about retiring the debt. That is exactly again what Winston Churchill said. We can preserve the value of bonds through the achievement of stability of prices, economic stability and a growing national income. That is the essential criterion.

It is not a wild idea, this idea of modern fiscal policy. It is the idea of stability. None of these gentlemen has said one word about how we are going to prevent depression.

I submit that Professor Fairchild is interested in the question of maintaining public credit. He thinks that you can maintain public credit merely by balancing the budget, merely by retiring the debt. Suppose that in fact under his program (and it was his program that was followed before the collapse of 1929) you have a terrific depression and a fall in income. What do you think will happen to the public credit? That is exactly what Churchill meant. That is exactly what Sir James Steuart meant, about preserving the value of the public credit.

You can't defend the public credit of the United States merely by balancing the budget. That may be exactly the way to ruin the public credit of the United States, because the public credit of this great country depends fundamentally on the national income. We were rapidly moving toward national bankruptcy from 1929 to 1932 when budget-balancing ideas were in full swing. If we have a rising national income which increasing productivity will provide us, if we maintain economic stability, if we prevent both inflation and deflation, we can be sure that the public credit will be thoroughly maintained. We need to pursue a fiscal policy which will promote economic stability and a rising real income.

So it is not so simple a matter as just to say: "Lo and behold, let's go and balance the budget, and retire the debt." The question of what happens to the income, what happens to depression, is the all-important one.

It was suggested that we don't know what the national income is going to be under the modern fiscal policy. It was suggested that it may fall to a very low level. That is exactly the purpose, the aim and the end of a rational fiscal policy, to prevent the national income falling, and we have the means by which we can do it.

We must have an ever-rising national income. Why? If we let the national income fall now to the level of 1929, we should have, by reason of increased productivity, and partly by reason of the increase in population, between 18 and 20 million unemployed today. The ever-increasing man-hour productivity that has been going on for a hundred years means we must have an ever-rising national income or else a tremendous volume of unemployment. We must achieve an ever-rising national income, and we can if we adopt a modern compensatory and developmental fiscal program. With an ever-rising na-

tional income, the ratio of debt to the national income need not rise.

Our public debt will be quite manageable after this war; Professor Fairchild says it is. If we had asked him three years ago, or four years ago, if a national debt of $300 billion was manageable I think he would certainly have said it is not—at least everything that he then said pointed to that conclusion. Now he says that it is manageable because we have it. There isn't anyone that I know of who denies that the debt we shall have at the end of this war is a perfectly manageable debt.

If that is so (and if the income rises at the rate of three per cent or so a year, and as it must so rise, or else unemployment will become intolerable), then it follows that if manageable now, it will remain manageable if debt rises percentage-wise no more rapidly than the rise in real income.

CHAIRMAN SHOUP: Professor Fairchild, would you care to give us a recapitulation?

Summary by Professor Fairchild

PROFESSOR FAIRCHILD: Mr. Chairman and Ladies and Gentlemen: You have listened very patiently to me, and as I know I have already overstepped my time limit, I don't want to impose upon you further.

Only one or two points occur to me which seem to call for some response at this time. If, according to the last speaker, I had been asked three or four years ago if $300 billion of debt was manageable, I would certainly not have said either yes or no. If Mr. Hansen had been as assiduous in studying my publications as I have his—I flatter myself, of course, in assuming that he might have done so—the one thing he would have gathered would be that, of all things, I have avoided any statement of the amount of the public debt that the nation can carry. Even when we were talking about $50 billion as being the limit which the nation could carry, I disclaimed knowing what was the debt that would be borne.

I have said all along that this is not the point. The point is, what are we going to do about the debt?

That leads me to the one and sufficient answer to all that Mr. Hansen has just said. With most of what he has said as to ideals, desirability of a large and increasing national income, and so on, I agree—we would all agree with that. The one thing which I cannot follow is the alleged efficacy of the continuously growing public debt to accomplish those things, and having said that I think I have said all.

In my original address I claimed that this new debt theory which Mr. Hansen has again brought before you has never been proved by the test of sound logical argument and, so far from ever being proved, has been disproved by the experience of history. I cannot see that any new propositions have been presented which I did not have in mind when I prepared my address. I did the best I could to cover them in the time to which I was limited. If I had had more time, I would have said more.

I appreciate the patience with which you have listened to me, and if this meeting is to continue further, I think the time should be given to others who have not spoken so much as I have.

CHAIRMAN SHOUP: The meeting is adjourned.

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ROLAND I. ROBINSON

Monetary Aspects of National Debt Policy

MANAGEMENT of the postwar debt involves much monetary economics. A large part of the debt is owned by the banks, whose assets are heavily weighted with public securities. Some indication of the problems encountered here is afforded in the following discussion of debt management by staff members of the federal reserve banking system: *

The primary objective of postwar management of the public debt must be economic stability, but this in turn, if it is to be achieved, requires monetary stability. The wartime expansion of the Federal debt has already caused a vast increase in money holdings and has weakened the resistance of the economy to further monetary expansion. If large postwar demands for capital outlays and deferred consumption should create the initial conditions of inflation, the money supply, already large, could under present conditions expand further and so prevent the realization of even approximate monetary stability.

There are indeed other objectives of debt management than monetary stability. The budgetary problems of the Federal Government would be simplified by a low debt service charge. Other considerations permitting, it would be desirable to avoid instability in the market value of Government securities. The large debt should not be permitted to create a new or expanded rentier class. But all of these objectives are subsidiary; if conflicts between objectives should emerge, they must be resolved in favor of monetary stability.

Discussion of the effect of the national debt and its management on monetary stability is focused on the long-range possibility of inflation, not because inflation is more likely than deflation, but because it is the powers of the credit authorities to resist further credit expansion that have been impaired by the wartime increase in the Federal debt. Unavoidable inertia toward modifying the debt structure and the overhang of contractual rights and obligations probably means that the structure of the debt cannot be modified quickly enough to meet transitional postwar inflation should it develop. The wartime tax structure and such direct controls as are still in effect are much more suitable weapons for that purpose. For the longer term, however, these instruments will be much less

* *Public Finance and Full Employment* (Washington, D.C.: Board of Governors of the Federal Reserve System, Dec. 1945), pp. 69–83.

potent and unless the problems of debt management are met, the possibility of unwarranted monetary expansion will persist.

If a general inflationary problem in the postwar should arise from a steady excess of business and consumer capital expenditures over savings, the appropriate offset would be a budget surplus which would be used to retire public debt held in the banking system and therefore to limit the growth or possibly even contract the volume of deposits and currency. But if inflationary developments should come rapidly, the retirement of debt with budgetary surpluses would be too slow to be an effective control. The direct controls which have been instrumental in preventing excessive use of monetary holdings during the war could not and should not be revived at such a time. It is to prepare for the contingency of marked inflation in the absence of direct controls that there is advanced at the end of this paper a series of suggestions for stabilizing Government security ownership and revitalizing the quantitative credit controls.

TABLE I

OWNERSHIP OF FEDERAL DEBT

Holders of debt	Dec. 31, 1939 (In billions of dollars)	Sept. 30, 1945 (In billions of dollars)	Percentage Distribution of Debt Held Outside Government	
			Total Sept. 30, 1945	Increase Dec. 31, 1939 to Sept. 30, 1945
Total Federal debt outstanding	47.1	260.2		
Held by U.S. Government agencies and trust funds	6.5	26.6		
Held outside Federal Government	40.6	233.5	100.0	100.0
Commercial and Federal Reserve Banks	18.4	106.8	45.7	45.8
Individuals	9.8	58.5	25.1	25.3
Corporations	2.7	30.0	12.9	14.2
Insurance companies and mutual savings banks	9.4	33.2	14.2	12.3
Other	0.3	5.0	2.1	2.4

Source.—Published regularly in the *Treasury Bulletin;* corporation includes "other associations," dealers' brokers, and foreigners. Individuals include unincorporated business. The "other" category consists mainly of State and local governments.

Monetary Expansion During the War

The wartime expansion of the Federal debt has been responsible for a very large growth in currency and deposits. Great efforts have been made in the War Loan drives and through pay-roll deduction plans to sell securities to individuals and corporations and other nonbank buyers. But what could not be sold this way had to be sold to the banks.

Either directly or indirectly new funds so created passed into the hands of private owners and were held as demand deposits, savings accounts, or currency. In a very broad sense, the proportion of the federal debt sold to the banking system is an index of the proportion of wartime savings in money form. The distribution of Federal security ownership and of its wartime increase is shown in Table 1.

Almost half of the United States Government securities held outside of the Federal Government are owned by the banking system and about the same proportion of the increase in net Federal debt since the end of 1939 was absorbed by the banking system. A little over one-quarter of the increase has been taken by individuals and about one-seventh by corporations (excluding banks and insurance companies). Insurance companies and mutual savings banks have accounted for about one-ninth.

Some expansion of deposits and currency would, of course, have been appropriate to the wartime growth of production and income. Expanded production and income call for larger working balances. Even a more than proportionate growth in cash balances is justified. In the first place the uncertainties of war are legitimate grounds for larger precautionary balances. Furthermore, in the case of business concerns the inability to make capital expenditures as great as depreciation allowances and other business reserves has tended to build up cash balances.

But the creation of new money has very substantially exceeded the growth of production and national income and some further expansion seems unavoidable. The present (late —1945) levels of demand deposits and currency are more than three and one-half times prewar levels, and total liquid assets have grown by the same proportion. Over the same period, gross national product at current prices and income payments to individuals have both expanded about two and one-half times, as is shown in Table 2.

TABLE 2

RELATIVE MONETARY EXPANSION

(1935–1939 = 100)

Year (June dates for liquid assets, deposits, and currency)	Gross National Product	Income Payments	Total Liquid Assets of Individuals and Corporations	Deposits and Currency	Demand Deposits and Currency
1935–1939	100	100	100	100	100
1939	108	105	108	108	112
1940	119	114	116	118	130
1941	147	138	128	131	155
1942	185	175	154	143	183
1943	230	213	226	187	261
1944	243	233	293	218	304
1945 (Est.)	242	245	357	260	354

In the postwar period, presumably, the need for idle or precau-

tionary balances will not be as great as it is now, since gross national product and income payments presumably will recede moderately from wartime levels even if full employment is maintained. In other words, present money levels are probably adequate, possibly excessive, for a number of years to come. The problem then is that of so managing the public debt that it does not lead to further monetary expansion.

Inflationary Potential of Present Debt Structure

Without further growth, the public debt could be the basis for considerable further expansion of the money supply. The selling of Government securities held outside the banking system to banks (including redemption of nonmarketable issues) and a growth of private indebtedness to banks would occasion such expansion. And banks would be able to expand credit in these circumstances because they have virtually uncurbed access to reserve funds.

Easy Access of Banks to Reserves. A necessary condition for bank credit expansion is the access of banks to additional reserves. With the present large volume of short-term Federal debt owned by the banks, it is extremely difficult, if not impossible, for credit authorities to use quantitative measures of monetary control to limit the access of banks to additional reserve funds. If banks seek to replenish their reserves by selling Government securities or by letting them mature without replacement, the banking system as a whole will secure an increase in reserve holdings, unless either one of two conditions is met. The first condition would be the existence in the Federal Treasury of adequate budget surpluses to retire debt equivalent in amount to the reduction of bank holdings. The second condition would be the presence of nonbank buyers for an amount equivalent to the reduction in bank holdings. But bank holdings, particularly of short-term securities, are so large that the amounts sold by the banking system could exceed any conceivable budget surplus. And the discipline of market price decline and capital loss is not very effective because banks can depend on maturing issues to supply any conceivable need for reserve funds. At present, commercial banks have more than 25 billion dollars of securities maturing within one year. Furthermore, in a period of emerging inflation it is not likely that nonbank buyers would appear in sufficient numbers, even with a considerable rise in interest rates. Consequently, net sales of securities by the commercial banking system would probably mean net purchases of securities by the Federal Reserve System and therefore an expansion of member bank reserve balances.

With reserves freely available about the only limitations on credit expansion by the banks would be either that demand was lacking or that the banks were reluctant to expand credit because of a shrinking ratio of capital to deposits. Even though the reliance of corporations upon bank credit has shown a secular tendency to decline, a private demand for bank credit could emerge under inflationary circumstances. We have no experience which would warrant reliance upon decreasing capital-deposit ratios to limit bank lending. Without an effective control of the access of banks

to reserves, further credit inflation would be possible.

Insecure Ownership of Government Securities. Further monetary expansion could occur if nonbank holders of short-term or redeemable issues were to show a general disposition to convert their holdings into cash. This would force the Government into further financing through the banks. If there is reasonable economic stability, this threat may not materialize; but inflation would change the picture. Fixed dollar obligations are not attractive when the price level is rising. And, if a price decline in Government securities or difficulties in refunding were given much publicity, the holders of savings bonds might redeem them in large volume, even though these holders were not directly affected by the fall in price of marketable securities.

Critical Matter Is Not Interest Rates Alone. The critical issue is not solely or even primarily, as it is sometimes argued, whether interest rates on the public debt should be stabilized or whether there should be flexibility in market rates: the structure of the debt itself—that is, the types of securities that evidence the debt—is equally important. With the present debt structure, dominated by short-term marketable debt and by nonmarketable issues redeemable virtually on demand, neither a stable nor a flexible interest rate policy will establish the conditions of monetary stability.

The policy of maintaining stability of interest rates and prices of Government securities makes virtually the whole public debt equivalent to money. It assures individual holders that they can convert their securities into money without appreciable capital loss. It would be hazardous to base monetary policy on the rather tenuous hope that this right would not be used. Banks, particularly, would be left as free agents since there would be no effective central control of their reserves. By selling Government securities, they could replenish reserves and finance private credit expansion.

Although stability of interest rates and bond prices might well impede monetary stability, it is by no means clear that a policy of permitting fluctuations in the rates and prices of Government securities would promote stability as long as the present public debt structure is retained. To be effective against inflation, higher interest rates would have to result in the conversion of idle or excess monetary balances into holdings of Government securities or into time deposits. In the long run, the rate of interest probably has a great deal of influence both on the employment and holding of money. But in the face of short-run inflationary developments of any real magnitude, a very great increase in interest rates might be necessary to resist the conversion of Government securities into deposits. Interest rates of 5 and 6 per cent on Government securities following the last war were not an adequate curb on credit expansion by banks and did not promote nonbanking absorption of Government securities to any significant extent. When prices of commodities can increase more than 10 per cent in a year, high interest rates probably do not have much effect.

Even with advancing rates, banks could afford to use Federal Government securities to replenish reserves. They could probably obtain higher rates from their customers, for rising interest rates are probably a very

weak impediment to private credit demands. The influence of short-term interest rates on business decisions may be slight, since in many cases interest is a small part of business costs. Speculative and expansionary activities in the past may have been inhibited less by high rates than by the underlying scarcity of funds.

Furthermore, flexible interest rates and fluctuating Government security prices present an obstacle to stable ownership of securities. Stable ownership of Government securities is itself a desirable goal because it minimizes the chances of concentrated periods of sale and redemption which lead to periods of concentration in expenditures. Some holders are no doubt attracted by the very fact of stability and would hesitate to hold any investment, no matter what the yield, if it were not "dependable." One practical problem is that banks often seem to be very sensitive to Government security prices, probably because of their capital position. Changes in the level of interest rates and therefore security prices in the past have sometimes led to concentrated and panicky selling of securities by banks. Offerings have sometimes come to the markets so precipitously that buyers could not be found without rapid and unnecessarily large markdowns in prices. In other words, once a change in prices is set in motion it may tend to go a considerable distance without finding an automatic corrective in the mechanisms of the market. And Federal Reserve buying in such circumstances, though "for the purpose of maintaining an orderly market," expands reserves and creates the potential of credit expansion.

It is sometimes maintained that there is a compromise policy that can be pursued even with the existing debt structure—a policy of maintaining "reasonable" stability in the long-term interest rate while permitting rather larger fluctuations in short-term interest rates. No appraisal of this compromise policy can be made without more exact definition of what is meant by "reasonable" stability in long-term yields. If this sort of stability means relatively narrow price fluctuation with a guarantee for a long period in the future, it is doubtful whether many short-term securities could be sold except at yields very close to the long-term rates. Why should investors hold short-term securities and accept an appreciably lower return if the long-term rate is held within fairly narrow margins? On the other hand, would the Treasury go to the short-term market if rates there were above the long-term rate? And in the absence of Treasury demand, and with prospective stability of the long-term rate, could a short-term rate higher than the long-term rate prevail?

Existence of fluctuation in the short-term rate requires that the long-term rate also move within margins wide enough to produce appreciable capital losses or gains and to endow longer term investment with enough risk to deter some investors. But, expanded to this range, the policy becomes essentially one of fully flexible interest rates and, as such, is subject to the limitations discussed above.

Practical Considerations in Public Debt Planning

The first part of this essay has been devoted mainly to diagnosis of

the shortcomings of the present debt structure for purposes of monetary control. The remainder will be devoted to prescription. Before undertaking to make concrete suggestions for changing the debt structure it is necessary to recollect a variety of practical considerations that must weigh in any public debt planning. Some of these considerations are more political than economic. The leading ones are:

1. Planning for financing the public debt must be done as a whole since special limitations or restrictions in one sector of the Government security market have immediate repercussions in all other sectors. In other words, such proposals as are later discussed for limitation of bank ownership carry with them an equally important corollary that dependable markets must be developed in other sectors of the economy.

2. The kind of new securities issues will have to allow for substantial changes in the structure of public debt ownership. Nonfinancial corporations. State and local governments, and some other groups cannot be expected to hold large amounts of the public debt indefinitely. Holdings may be liquidated by these groups at a greater rate than they can be absorbed by budget surpluses and may therefore have to be absorbed by individuals or by financial institutions. Public debt plans in the postwar period, therefore, should look toward not only steady but increasing ownership of Government securities by individuals, insurance companies, and savings banks.

3. Other factors being equal, the interest cost of carrying the Federal debt should be as low as possible. Practical budgetary considerations argue for low cost. Also, as explained in another paper in this pamphlet, interest payments on the Federal debt probably support consumption less than other types of Government expenditures.[1]

4. The sentiment to require price stability for all marketable Government securities must be recognized. The fact that Liberty Bonds declined to the low 80's following the last war is still pointed to as a breach of faith by the Government. It is not clear that a politically sensitive administration could afford to permit much price fluctuation in marketable issues.

5. The credit authorities should have freedom of action to deal with either inflationary or deflationary circumstances. The proper preparation of the credit authorities is to secure a strategic position that will permit tactical operations against whichever kind of condition emerges.

Proposed Changes in Public Debt Structure

The changes in the public debt structure proposed in this essay have been framed with the idea of establishing the minimum prerequisites for effective monetary control while meeting the other objectives of debt management as far as possible, i.e., permitting the changes in public debt ownership that are needed to facilitate business financing, avoiding wide fluctuations in Government security prices, and minimizing the cost of the public debt. The greatest change would concern bank ownership of Government securities.

The burden of proof must be on any proposal for change in the struc-

[1] Henry C. Wallich, "Public Debt and Income Flow," pp. 84–100.

ture of the public debt. Change is itself unsettling. It may foster irrational doubts and create unsettled markets. Change must not only offer real advantages but the advantages must be clearly evident. The fact that nonmarketable issues sold so far are redeemable practically on demand and the fact that prices of nonmarketable issues have been stabilized have vested holders with rights that are hard to withdraw or negate. Without compulsion the only way to do this is to offer holders even more attractive rights in other forms.

In the proposals that follow, the only economic interests that might appear to suffer any loss of rights are the commercial banks. But if the case is considered broadly they also will gain by the change. Banks stand to lose from monetary instability as much as any group. Moreover, settlement of the vexing problem of public debt financing opens up the prospect for a flexible interest rate policy with respect to private bank loans and investments. To the extent this meant higher interest rates, banks might profit greatly from the change. Without some modification of the present financing arrangements, interest rates would possibly not be allowed to rise, and hence the whole awkward paraphernalia of restricted issues and similar devices would be retained and even extended in the effort to keep banks from profiting unreasonably from holding Government securities.

Public Debt in the Banking System. Stabilization of interest rates on Government securities reduces the effectiveness of credit control. Ownership of a large volume of short-term Government securities by banks, even without interest rate stabilization, has almost the same effect since banks can secure additional reserve funds and with them take an active, even an aggressive, role in expanding deposits. Any plan to put bank reserves under control must in some way subject bank ownership of Government securities to direct control. The banking system must earn its living and justify its existence by supplying credit for business and consumption, not by relying upon its ability to monetize the public debt.

The exact means for accomplishing this end cannot be specified without a great deal of further study. To be fair to the banks the device adopted should allow for substantial differences among banks in present holdings of Government securities and should permit legitimate private demand for credit to be met. Some of the possible devices that have been suggested are as follows:

1. Require banks to invest an amount equal to some proportion of demand deposits in a special nonmarketable Government security redeemable only to meet deposit losses.

2. Require banks to hold an amount of a special nonmarketable Government security equal to increases in demand deposits after some base date such as December 31, 1939. A variant of this device would be to "freeze" holdings as of some recent base date but to permit each bank to vary its holdings as it lost or gained deposits.

3. Raise reserve requirements on demand deposits (and extend requirements to all commercial banks) but pay interest on reserve balances. Banks would meet these requirements by selling marketable Government securities to the Federal Reserve Banks. This would be akin to the 100 per cent reserve proposal.

This proposal is not made for the purpose of limiting bank earnings. The question is rather one of equity and it should be resolved by deciding which social group should bear the costs of operating the money system. For credit control purposes, the earnings permitted on bank holdings of Government securities might well be generous, though probably below the levels paid other holders of Government securities.

This much interference with the "rights" of private commercial banks cannot very well be avoided. In modern economic systems, the supply of money must be subject to Government regulation, if monetary instability is to be avoided. Because money has come to consist predominantly of the demand deposit obligations of commercial banks, these institutions—though privately owned—are unavoidably in the public sector; they must be subject to public regulation to a degree that is true of no other part of the business community.

One special reservation must be made for the commercial banks. The savings institutions should be permitted to carry Government obligations with an interest return at least as high as the present one. Since commercial banks also transact a large volume of savings business, they should have equal rights to participate in such types of investment to the extent that they hold savings deposits. Thus far, commercial banks with time deposits have not had access to as liberal supplies of long-term Government securities as pure savings banks have had.

Other Holders of Government Securities. If bank holdings of Government securities are to be restricted to special issues, it is equally important that adequate provision should be made for marketing the remainder of the debt. The ideal circumstance to be sought is one in which there would be such a steady and active demand that the new money and refunding needs of the Treasury could be fully met by the market outside the banking system at all times. It means that the securities offered should be made attractive and convenient for the class of holders for which ownership can be expected and should be encouraged.

It would probably be unwise to apply measures of compulsion to the holding of Government securities except in the case of commercial banks. The measures proposed, therefore, are more by way of added inducements, intended to increase the stability of ownership. So far as possible, these inducements should not increase the service cost of the public debt.

While the primary objective in the treatment of nonbanking investors is to secure stability of ownership, other worthwhile ends can be served. To the extent that business concerns own Government securities, they are a source of funds for financing capital outlays that should not be closed off. For institutional investors such as insurance companies and savings banks, these securities offer relatively liquid reserves that permit the companies more freedom in the management of other assets. For individuals the securities offer a savings vehicle and a supplement to social and personal security that should help to encourage more adequate consumption from current income. Planning of debt ownership for individuals should offer incentives for steady and well-maintained consumption while at the same time penalizing

excessive concentration of consumption expenditures at irregular intervals of time.

Because the circumstances of ownership vary for the important holder groups—corporations, insurance companies and savings banks, and individuals—the plan of offering for each group is set forth separately.

In the long run, it is doubtful whether *corporations* should be expected to continue to be substantial holders of Government securities. Business corporations are normally net demanders of capital, not suppliers. Reduction of the great tax liabilities incurred during the war period together with postwar capital expenditures should tend to reduce corporate ownership. No doubt a small residual amount will continue indefinitely. Government issues intended for purchase by corporations are now dominated by certificates of indebtedness and tax savings notes and might very well be left pretty much in their present form.

Ownership of Government securities by *insurance companies* and *savings banks* tends to be stable and there might be relatively little advantage in refunding the sort of obligation they now hold. For ordinary purposes, a stable market could probably be assured for outstanding issues by adjustment of the Government's trust accounts whose holdings are now largely in the form of special issues. Except in periods of depression these trust accounts will continue to be absorbers of Government securities. Buying and selling for these trust accounts, perhaps through the agency of the Federal Reserve open market account, could be used to stabilize the market for securities now held by insurance companies and savings banks.

It may be reasonably expected after the aggregate debt has stopped growing that some important groups of holders of Government securities, such as *nonfinancial corporations* and *State and local governments,* will tend to draw on their cash and Government security holdings. It is doubtful if budget surpluses sufficient to absorb this net selling can reasonably be expected for some time after the war. For this reason plans should be made so that *individuals* will continue to absorb more of the public debt, in order to keep this part of the debt from gravitating into the banking system and creating more deposits and currency. Of course, some individuals will be sellers but for the group as a whole continued absorption must be planned. Although to prevent inflation it would be desirable to assure adequate savings by individuals, in order to prevent deflation the savings incentives should not be set too high. The following proposals, therefore, attempt to provide assurance of normally stable holding by individuals together with some incentives for further acquisition, but they also have various features providing long-run encouragement to stable consumption. The proposals look toward conversion of present holdings and shaping of new offerings in three general forms:

1. The Treasury could offer to sell unemployment insurance which would be in addition to (and in no case restrictive of) unemployment compensation provided under the social security provisions of the Federal Government and the States. This insurance could be administered through existing channels. Purchasers could be permitted to

exchange present holdings of savings bonds for the insurance or to pay for it out of future savings. The exchange offer could be held open for a fixed period only and the sales offering of insurance for new savings could be made only when there was need for encouraging savings.

Government receipts and expenditures under this plan would have a stabilizing effect on the economy. If reasonably full employment prevailed, public debt would be retired; if unemployment increased, the payment of insurance benefits would encourage consumption. Both actions would come at the right time to smooth fluctuations in economic activity.

2. The Treasury could offer life and beneficiary annuities in exchange for present holdings of savings bonds and, in periods when additional savings are needed, through special offerings for cash. Cash offerings could be made through the insurance companies if Government competition in the insurance field were feared. This sort of arrangement serves the purpose of promoting stability in ownership while ultimately tending to encourage stable consumption.

3. The Treasury could offer stable purchasing power bonds in exchange for any Government security held by an individual. New offerings could also be made in this form. Since stability of real values is unavoidably jeopardized by the after effects of war finance, this sort of offering is equitable.

Stable purchasing power bonds could and probably should be nonmarketable in form and if so should be redeemable only with some penalty. A sliding scale of interest rates such as now applies to savings bonds might be utilized. This plan would be aimed mainly at investors for whom maintenance of purchasing power is important. It is possible, of course, that the stable purchasing power provision might also be made on each of the other two types of offerings outlined above.

Even with the considerable attractiveness of these offers, all of the outstanding issues held by individuals would not be converted. Those not converted but not redeemed or marketed need cause no concern. The money raised by the new plans might be sufficient to absorb issues redeemed for cash before maturity. Market operations for the Treasury trust funds might be used to take up any remaining slack.

Credit Policy with Proposed Debt Structure

If the public debt should be refunded largely into nonmarketable obligations as these proposals contemplate, the Reserve System would no longer effect its credit policy mainly through open-market operations. Credit policy would then be a direct function of debt management (which it is indirectly, in any event). When expansion was desired, an additional supply of the special bank securities could be made available to the banking system. When monetary contraction was in order, the special issues held by banks could be retired and replaced by issues sold to nonbanking holders. Under some circumstances these direct adjustments of money supply would no doubt have to be coordinated with or used to offset open-market transactions by the Federal Reserve System for other purposes. The result would be firmer control than now exists. When open-market operations

are used to influence the price of Government securities as well as to adjust the volume of reserve funds, it is not always possible to reconcile precisely these two objectives. If prices on Government securities were no longer at stake, credit operations could either tighten or relax the money market much more precisely. By removing Government securities from the market, it would make possible the revival of credit policies which would vary the cost and availability of funds to private borrowers.

With credit policy effected mainly through direct adjustment of the Government securities held by the banking system, it would be possible to coordinate credit and monetary policy, on the one hand, and general requirements of fiscal policy on the other. When inflationary factors predominated, appropriate fiscal policy would presumably result in budget surpluses. These surpluses could be used to reduce bank holdings of Government securities, which would reduce the money supply or at least curb its growth. Conversely, in periods in which depression elements predominated and in which fiscal policies resulted in deficits, the added debt could be channeled mainly into monetary expansion, if such were thought to be useful.

But What about Deflation?

The proposals made so far have been intended mainly to meet the possibilities of inflation. Would they weaken the power of the monetary authorities to cope with deflation? If deflationary circumstances arose, the system of nonmarketable Government issues would still permit the easing of bank reserves even if the aggregate of public debt were not increasing. But if public deficits should accompany these developments, as they probably would, the direct control of bank holdings of Government securities would furnish a vehicle for monetary expansion. New reserves and new earning assets resulting from the increased debt could be channeled into the banking system. The effectiveness of monetary expansion in such circumstances is not the issue; the point is that the credit authorities would have as effective powers to combat deflation as they have with the present public debt structure.

COMMENTS BY CHARLES O. HARDY *

Monetary Aspects of National Debt Policy.—The most important innovation which Mr. Robinson suggests is the requirement of a reserve against demand deposits, consisting of nonmarketable low-yield securities (pages 77–78). Three alternative plans are proposed. Mr. Robinson does not state precisely what purposes are to be accomplished by

* *Ibid.*, pp. 139–143.

these measures, though he indicates that the purpose is not to reduce bank earnings. Inferentially, the aims are to reduce bank speculation in securities, to reduce the interest burden on the Treasury, and/or to improve the machinery of credit control.

The proposals all seem sound in so far as their purpose is cheapening the cost of Treasury borrowing. When the note-issue privilege was attached to Government bond issues under the old national banking system, the Treasury was enabled to borrow more cheaply than other sound borrowers; a similar saving could be made by attaching special privileges to bonds as coverage for deposits, as Mr. Robinson suggests.

In their details, the plans are open to several objections. First, as a means for eliminating speculation in Government bonds the plans can not be very effective so long as the banks are free to trade in marketable securities on the basis of their time deposits.

Second, the plans put a much greater premium on the deposit of funds in time accounts than does the present differential in reserve requirements. It will be remembered that in the period of very active demand for loans in the twenties, deposits were shifted extensively from the demand to the time category although the only gain to banks was a reduction in cash reserve requirements.

Third, I do not see that any of the three plans really accomplish the purpose of giving the monetary authorities more effective control than they already have, since, so far as indicated, the Reserve System or other monetary authority is not to have discretion to raise and lower the level of required bond reserves. Moreover, even if the control authorities are given power to change reserve requirements, they cannot exercise restraint without tightening money markets; if that cannot be allowed now, it cannot under the new system.

I confess that I do not understand the section "Credit Policy with Proposed Debt Structure" on pages 81–82. If an additional supply of special bank securities were made available to the banking system in dull times the banks would have no need for them unless deposits were increasing. They would have no way to pay for them without liquidating outstanding credits unless they already had excess reserves. If they did buy them no purchasing power would be created; excess reserves would merely be shifted from one form to another. Vice versa, for the Treasury to retire the special bonds in times of expansion would make the banks' bond reserves deficient and their cash reserves excessive. It would seem more sensible to make the cash reserves deficient since that would bring direct pressure on each individual bank to call its loans or sell its assets. A bank which was short merely of bonds, not cash reserves, could bring down its deposit liabilities by inducing depositors to take cash in exchange for demand deposits, but that would merely substitute one form of money for another without correcting the monetary situation at all. Sale of marketable securities would reduce deposits somewhere in the system but not primarily in the selling bank. Calling loans, likewise, would not help the individual bank except as its debtors might pay by check on the bank itself.

I do not see any argument for the

proposal that the price of marketable securities held outside the banking system should be stabilized by open-market operations on the part of the Government trust accounts. To perform this function the trust accounts would have to carry normally a large balance of uninvested cash so as to be ready to intervene on the buying side of the market. They would thus become a second central bank, buying bonds when interest rates are rising and selling them when interest rates are falling. This would run directly counter to the use of Federal Reserve credit policy to check monetary expansions and contractions, since open-market sales for credit control ordinarily occur when interest rates are rising and open-market purchases when rates are falling. This dilemma is not resolved by the provision that the operations might be "conducted" by the Open Market Committee of the Federal Reserve System, so long as the purposes conflict. As the author states on page 74, stabilization of interest rates and bond prices is an impediment to monetary stabilization; it is not desirable to have one central bank responsible for stabilizing bond prices and another for stabilizing monetary conditions.

Mr. Robinson's three plans for stabilizing individual holdings might lead to absorption of some of the current excess of individuals' purchasing power. But the volume so absorbed would probably be insignificant if the Treasury insisted on getting its funds even as cheaply as it does now. If the life annuities are to carry no privilege of redemption, the rates will have to be lower than those now offered by life insurance companies with redemption privileges; and annuities can be bought now at yields higher than those of bonds. I do not see how the cost of the Treasury could be less than 3 per cent in the current market.

As to the offer of unemployment insurance, it is true, as the author states, that Government receipts and expenditures would have a stabilizing effect on the economy. But a plan of voluntary unemployment insurance would have to be very expensive for the Treasury in order to be attractive to the individual. If the insurance was paid for currently and was immediately effective, like fire insurance, individuals would naturally postpone purchase until they expected to be unemployed in the near future. It would be like life insurance without any medical examination; the dying would all want it. On the other hand, if an individual had to participate for a long time in order to build up his benefit claim, and had no right of redemption, it is hard to see how the insurance could be sufficiently attractive unless the rates were too low to cover the losses. Moreover, it does not seem practicable to withdraw the offering of unemployment insurance in a time of deflation, as suggested, since that is just the time in which popular demand for it, if any, would be greatest.

The proposed stable purchasing power bond would offer the investor a hedge against changes in the cost of living, which would perhaps be accepted as an offset to a low coupon rate. But the risk taken off the investor would be transferred to the Treasury, and this would be the equivalent of a higher rate on the debt. The stable purchasing power bond needs further explanation before its merits can be determined. Would the bond be redeem-

able on a sliding scale, varying with the cost of living, or would only the interest be stabilized in purchasing power? If the former, the bonds would offer a grand opportunity for speculation, the holder redeeming the bonds when he believed that the cost of living was going to fall, and buying them when he thought it was going to rise. However, if the redemption value were fixed in dollars, at or slightly below the issue price, and only the interest disbursements adjusted to the purchasing power of the dollar, this objection would not hold. But the plan would work in direct opposition to the cyclical stabilization feature of the proposed unemployment insurance, since the disbursements would be greatest in periods of inflation and least in periods of deflation. At present we have two institutions which will powerfully reinforce any inflationary movement that may start: the farm price parity program and the principle that wages should be adjusted upward with the cost of living. Mr. Robinson's proposal makes it complete. The rentier too will have his income automatically raised by inflation and there will be no one whose reduced purchasing power will serve as a check on the inflation

I think Mr. Robinson has attempted the impossible. He is trying to eliminate inflationary pressure while perpetuating its principal prospective causes. One of these is the principle that whenever the Treasury is a borrower it must have access to cheap money, obtained if necessary by inflating the volume of liquid funds in the hands of the public. For the bulk of wartime borrowing this decision is irremediable; Mr. Robinson would continue it whenever the Treasury is a borrower in time of peace. The second is the policy recommended by Mr. Robinson of stabilizing the price of marketable Government securities for an indefinite period after the war financing is finished (page 76). I do not believe that there is now any necessity for this, moral or political. I never heard anyone refer to the decline of bond prices in the early twenties as a breach of faith. But if the market is kept stable for a few years an implied commitment will be made, from which it will be hard to recede. A high bond yield may not of itself stop inflation, but it is a necessary by-product of the only measure that is sure to stop it; namely, the creation of an underlying scarcity of money.

HENRY C. WALLICH

The Changing Significance of the Interest Rate

OF PRINCIPAL concern in postwar public debt management is public policy with regard to the interest rate. This has broad implications for general economic policy. The many aspects of this problem are well summarized as follows: *

Conclusions

Our discussion has confirmed, I believe, the view put forward at the outset, that the interest rate today is more of a factor influencing the volume and distribution of income than an instrument of cyclical control. It has also yielded several conclusions about current interest policy, which I proceed to summarize.

1. We have found no single overriding consideration calling for any particular kind of overall interest policy—higher rates, lower rates, or stable rates. Instead, we have come across a number of separate desiderata, many of them in conflict with each other and none weighty enough by itself to swing the issue. This is quite in line with the rather diffuse effect now characteristic of the interest rate.

2. Nevertheless, among these diffuse factors there are several which argue strongly against an extreme policy in either direction—a sharp rise or a sharp reduction in rates. The danger of a downward spiral, the need to maintain confidence in the public credit, and the position of the banks practically prohibit a severe tightening of credit. The danger of a wild boom in capital assets, the problems facing rentiers and endowed institutions, and the uncertainties of the future speak strongly—perhaps not quite so strongly—against a reduction in rates close to zero. But within reasonable limits, none of these aspects can be said to rule out any particular policy.

3. The needs of certain sectors and the requirements arising from particular conditions, which may be in conflict with the policy actually pursued, are often capable of being met, at least in part, by *ad hoc* solutions. If interest rates are low, the problems of small rentiers and endowed institutions could be met by special limited issues of higher coupon securities. The need for cyclical regulation of credit could be dealt with by operating directly on availability, instead of via interest rates. Embarrassingly high bank earnings could likewise be handled outside the main stream of interest policy.

4. The demands and needs which cannot be taken care of in this form must be compromised by overall in-

* Henry C. Wallich, "The Changing Significance of the Interest Rate," *American Economic Review,* XXXVI, No. 5 (December, 1946), 786–787. Reprinted by permission of the American Economic Association, Evanston, Ill.

terest policy. The policy best suited to reconcile conflicting claims would be one of stable rates for the present and also for the foreseeable future, unless long-run depression should develop. In that case, a moderate further reduction in rates would be desirable. This view rests upon the following considerations:

(*a*) Under present conditions of high income and inflationary pressure, the aspects calling for lower rates—more equal income distribution, reduction in overall propensity to save, and stimulation of investment—lose much of their importance. They would gain weight if long-run deflation trends should develop.

(*b*) The cost of the public debt, which likewise speaks in favor of lower rates, is less important than its dollar amount would indicate, and should not be allowed to weigh heavily in our considerations.

(*c*) Factors suggesting higher rates —inflation control and the needs of rentiers and endowed institutions—likewise do not carry enough weight to make them decisive, particularly when they can be dealt with by *ad hoc* measures. They do, however, add to the case against a further lowering of rates now.

(*d*) Under present conditions, stability in the value of capital assets is preferable to a sharp move in either direction. This stability would be aided by stable rates.

The general picture of interest policy which thus takes form is one of increasing compartmentalization of the market and an absence of fixed commitments. This will enable us to deal with special aspects on their own merits, and to meet broader situations as they develop.

The proposed approach is very much at variance with diverse alternatives of public debt policy currently proposed—refunding of the debt at higher rates, uniform conversion of the debt into consols, or sharp reduction of rates. It is much closer to the policies actually being pursued. It suggests, however, that the practice of market differentiation already adopted in an embryonic form should be carried to its logical conclusion, and that more attention should be given to the broader impact of interest rates and less to special factors like bank earnings and budgetary costs.

ALVIN H. HANSEN
HARVEY S. PERLOFF

Local Debt and National Fiscal Policy

CERTAIN aspects of state and local debt, particularly the problem of controlling the quantity and quality of this debt, are considered in the following selection: *

Debt Limitations

Finally, the current legal debt limits on local governments possess neither economic nor political justification, and have in general been irrationally applied. In many cases, the present limitations are too rigid; in other instances debt limits have proved ineffective and communities have burdened themselves with excessive debt. Both these extremes can be avoided by placing debt limitations upon a rational basis.

Debt limitations have normally taken the form of a percentage of assessed valuation of real property within the locality. This limitation, as applied, has had little meaning in some jurisdictions, but it has been applied in an unduly restrictive manner in others. This type of limit has many defects:[1] (1) As a criterion of the capacity to finance debt services other measures than property assessments are important, including property-tax collections, revenues from all other sources, and the fiscal condition of the locality. (2) There are wide variations in the assessment ratio between different areas; little uniformity in debt control can, therefore, be achieved. (3) A local unit may arbitrarily raise its assessments in order to issue bonds after it has borrowed up to the legal limit. (4) Overlapping debt is not taken into account in applying the limitation. (5) Special assessment bonds and "revenue" bonds are generally exempted from the limitation. (6) In a depression, local debt margins decline with the shrinkage of property values, thereby impairing expansionist programs at just the time when they are needed and can be undertaken most economically. (7) Existing debt limits have led to an irrational and wasteful increase in the number of governmental units specifically created to borrow beyond existing debt margins.

These criticisms cannot easily be met by any single plan, but the

[1] See Bureau of Government, University of Michigan, *State Supervision of Local Borrowing*, Michigan Pamphlets No. 15 (1942), pp. 29–30. See also Leroy A. Shattuck, Jr., *Municipal Indebtedness, a Study of the Debt-to-Property Ratio* (Baltimore: The Johns Hopkins Press, 1940).

* Reprinted from *State and Local Finance in the National Economy* by Alvin H. Hansen and Harvey S. Perloff, by permission of the publishers, W. W. Norton & Company, Inc., New York. Pages 205–209.

method of control can obviously be improved. Instead of the limitation being a percentage of assessed valuations, the basis of the debt limit might better be a given percentage of revenues—including tax collections, fees and licenses, shared taxes, and surpluses from public-service enterprises available for general-fund purposes—but excluding revolving-fund income from public-service enterprises and special-purpose grants from higher levels of government. This would give a far more accurate picture of the actual ability of the locality to meet debt services. Property tax collections in 1940, for example, ranged from 86.2 per cent of total revenues in Erie to 42.5 per cent of revenues in Tacoma. Any other individual revenue source will vary similarly between cities. Contributions from public-service enterprises in 1940 amounted to 30.3 per cent of revenues in Jacksonville, while a number of cities had to cover utility deficits.[2] Such variations point to the necessity for including all revenues in the debt-limit base. A further improvement in the base could be achieved by using a moving average of a number of years, possibly five. This would permit reasonable planning on the basis of a more stable debt limit. If this proposal were adopted the debt margin would not contract so sharply in a period of depression and the scope for borrowing when the need is the greatest would be less seriously restricted.[3]

It should be clear that the chief objective of any local debt limitation is (or at least should be) to prevent the piling up of burdensome debt-service charges which would eat into the revenues of the localities and hamper flexible financing and programming. Debt service is a rigid item in local budgets, often rendering the financing of necessary social services difficult. There is no reason why the debt limitation should not be designed to fulfill its objective directly. Thus, the logic of the proposed limitation flows from the basic decision as to what percentage of revenues can be diverted to debt services without unfortunate consequences for the functioning of the local units. In determining the exact debt limit, two other factors must be taken into account: the average interest charges paid by localities within the state, and the average amortization period. Because these items change over time, the debt-limit regulations should be periodically re-examined.

Let us consider a hypothetical case. Assume that on the basis of a careful study of debt behavior and experience of the subordinate units of a given state, it is determined that local debt-service charges should at no time exceed one-fourth of local revenues. Assume further that the average interest charges on local borrowing, within the past three or

[2] U.S. Bureau of the Census, *Financial Statistics of Cities, 1940,* Vol. 2, Analytical Reports—Municipal Finances in 1940 (Washington, 1942), p. 18.

[3] Karl Scholz has demonstrated that if Philadelphia had introduced a nine-year moving average, as the base, the debt margin would have varied inversely with the cycle. The boom period would have found the city unable to borrow, while the depression would be characterized by an enlarged debt margin (Karl Scholz, *Municipal Borrowing Power, Debts, and Unemployment,* Pennsylvania State Planning Board, February 1937). The N.Y. State Constitutional Convention Committee proposed a five-year moving average (New York State Constitutional Convention Committee, *Problems Relating to Taxation and Finance,* X [1938], 307–311).

four years, has been 4 per cent, and the average amortization period, 20 years. The maximum debt for communities within the state might then be set at approximately three times the average revenue (i.e., of the average annual revenues for the past five years), making some allowance for emergency purpose.[4]

The limit should apply to all debt serviced through the tax system. This would include "limited" and "special" tax obligations as well as unlimited tax obligations, and also deficits arising from projects financed by revenue bonds and defaults on special assessment bonds. That is, revenue bonds and special assessment bonds would be exempt from the debt limit only to the extent that the revenues from the project or system cover the debt charges (i.e., are self-liquidating); the tax-supported share should be subject to the debt limit. Short-term credit in the form of tax-anticipation notes up to, say, one-half of average revenues should also be exempt. To prevent these exempted items from becoming loopholes for evasion, high administrative standards would have to be enforced by Local-Government Commissions in each state.

As the debt approaches its maximum it should become progressively more difficult to borrow. Moreover, the limit should not be considered automatic, but rather should be subject to additional administrative control. No mechanical limit alone can be established which will provide effective control of municipal debt. Under the assumption made, a debt equal to 150 per cent of revenues might be authorized by council vote and a referendum. The second debt volume equal to an additional 125 per cent of revenues should require the approval of a state Local-Government Commission.[5] Additional debt, amounting to 25 per cent of revenues, might be permitted for emergency purposes, possibly with the proviso that such funds be obtained from the Intergovernmental Loan Corporation. This type of reform[6] would place debt restraints on a more rational basis and would allow a greater degree of flexibility in credit management than now exists.

The use of state Local-Govern-

[4] The calculation is made on the basis of amortization through 20-year serial bonds, payable in equal annual installments. Thus, under the assumptions set up, the annual provision for debt retirement would be 5 per cent and for interest 4 per cent, or a total of 9 per cent. To determine the maximum debt which would involve debt-service charges of no more than 25 per cent of revenues: 9 per cent of total debt = 25 per cent of average revenue, so that the total debt is 25/9 times the average revenue.

[5] North Carolina has had a very instructive experience with its Local-Government Commission. It must approve all bonds and notes. If rejected, the local unit may submit the issue for a referendum and overrule their decision. Even if approved by the commission, the issues must be brought before the people, if it is for purposes not classified as "necessary expenses," or if the issue would make the total borrowings during the fiscal year exceed two-thirds of the amount by which the outstanding debt of the local unit was reduced during the preceding year. Exceptions to this limit are funding and refunding issues, tax-anticipation notes not exceeding 50 per cent of predicted revenues, casual deficit notes, and loans to suppress riot and repel invasion. See James W. Fesler, "North Carolina's Local Government Commission," *National Municipal Review,* XXX (June 1941), 327–334.

[6] A similar program of debt limitations has been suggested by Ben Ratchford, *American State Debts* (Durham, N.C., 1941), pp. 592–599. Another well-conceived suggestion is presented by the Bureau of Government of the University of Michigan, *State Supervision of Local Borrowing,* pp. 39–40.

ment Commissions or Departments is one of the most promising innovations in debt control. Administrative control combined with technical assistance is necessary to complement a statutory debt limitation. A Local-Government Commission, in addition to supervising debt-limitation provisions and managing cooperative reserves, could assist localities in marketing their securities, advise them with respect to debt retirement, assist refunding, standardize accounting procedures, and act as a service agency in many similar ways. The success which existing Local-Government Commissions and Departments have had with the flexible control of local finance points to the desirability of an extension of this technique for state supervision and control.

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The War Inflation Problem

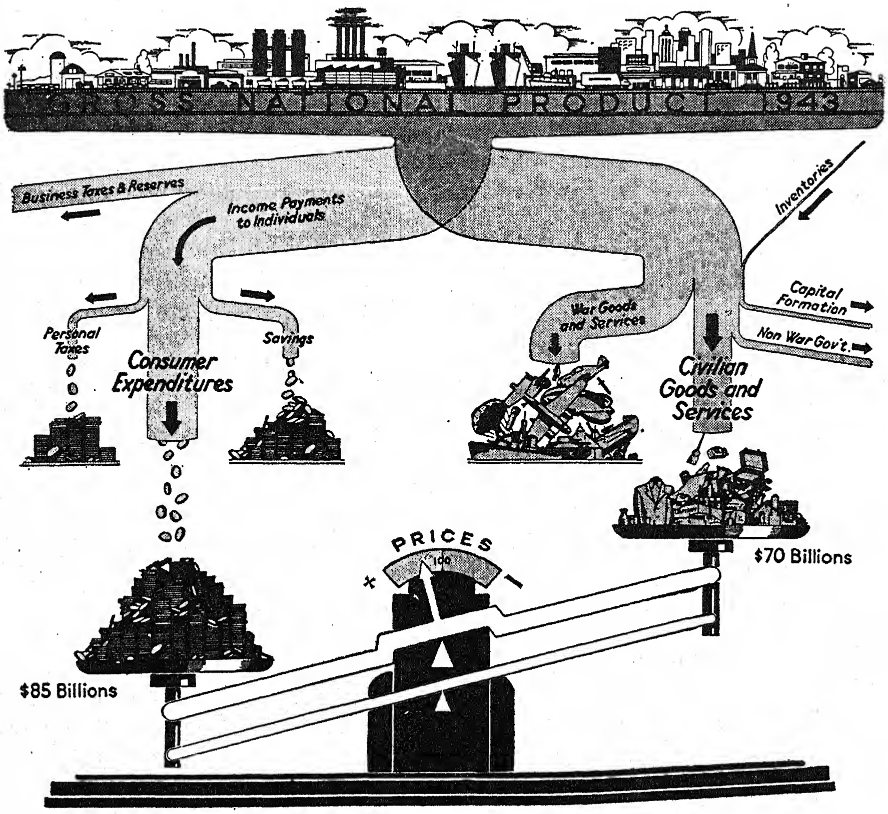
OF MAJOR concern during and after World War II was the inflationary effect of public borrowing. During the war the Treasury made the following presentation of the nature of this problem: *

The chart, reproduced here, was prepared in the Tax Research Division of the Treasury Department. In it the Division presents forecasts of the amount that consumers will try to spend in 1943 and the value at present prices of the goods and services they will find on the market. Business capital formation and nonwar Government expenditures, as indicated by the chart, are relatively small in contrast to the larger problem of consumer income and demand.

The chart reveals a serious lack of balance between consumer expenditures and the supply of goods and services. The implication here seems to be that the supply of goods and services must be increased or the amount of money coming on the market for consumer goods decreased in order to prevent a serious pressure on price ceilings and a sharp rise in prices. A sizable increase in goods available for civilian consumption obviously can be obtained only at the expense of reducing the volume of war production. If war production goals are to be realized little can be added to the civilian goods side of the scale. Presumably, the amount on the money side of the scale can be reduced only by withdrawing income before it gets on the market for consumer goods by means of increased taxes or increased savings or both.

* *Supplement to Public Policy Digest* (National Planning Association, Washington, D.C.), No. 28, Oct. 1942.

THE INFLATION PROBLEM



While the chart's main story is the unbalance which exists between the $85 billion for consumer expenditures and the $70 billion for civilian goods and services, it will be interesting to some persons to see estimates for the other items. Additional information which is presented in this Supplement is taken from a number of recent public addresses by Randolph Paul, General Counsel of the Treasury. These mimeographed statements may be obtained upon application to the Treasury Department, Washington.

Mr. Paul believes that the passage of the Second Price Control Act by Congress and the creation by the President of the Office of Economic Stabilization will make an invaluable contribution to the successful control of inflation. He goes into some detail regarding the increased use of taxation and savings as a further means of diminishing the inflation threat. According to Mr. Paul, the dimensions of the inflation problem are revealed by careful examination of the following figures:

The total of the income currently being received by all individuals in the nation is running at more than $115 billion a year . . . It is likely to reach $125 billion in the calendar year 1943. Even after all individual taxes payable directly to Federal, State and local governments, there will remain for spending or saving more than $110 billion . . .

The supply of goods and services available to consumers is currently running at the rate of $80 billion a year. An optimistic figure for 1943 is $70 billion. The difference between $110 billion and $70 billion, or $40 billion, is the inflation threat. . . . The best estimates of annual current saving run at less than $25 billion. If this rate of saving is maintained there will still be left $15 billion of purchasing power in excess of consumer goods available.

Unfortunately none of the addresses from which these figures are taken include the General Counsel's estimates for business taxes and reserves, for capital formation, or inventories. Neither is there a definite figure showing expenditures for war goods and services. Mr. Paul does point out, however, that the total war budget, requested in the 1942 Budget Message and in subsequent budget revisions, now stands at $78 billion, "which together with non-war Governmental expenditures makes a total for the fiscal year 1943 of $85 billion. With tax revenue augmented by the 1942 Act, which will be in operation for only part of the year, we shall still be left with the necessity of borrowing in the fiscal year 1943 more than $60 billion."

While Mr. Paul states the inflation problem in conventional monetary terms, he emphasizes that the basic problem is more fundamental. More people will have to work longer and more intensively next year than this year. "Harder work and the exhaustion of our capital, on the one hand, and a smaller supply of goods and services on the other hand contribute the price civilians must pay to win the war. They constitute the inescapable economic cost of the war.

"We should not delude ourselves into thinking that we have complete freedom in the distribution of this real cost of the war. We must compensate individuals who are working when they have not previously been working or who are working longer or who have changed from positions in the civilian economy to positions in the war economy. We can compensate them out of a diminishing supply of goods and services only through the sacrifices of others who for one reason or another are not being asked, or are not able, to work harder, longer, or in a new capacity. These persons, often described as the fixed income group, have no choice. No financial legerdemain, no tax panaceas, no verbal evasions, can protect the whole of the fixed income group from a larger than proportionate diminution of their standard of living.

"If we do nothing, the physical realities of today will inevitably develop into a disastrous inflation of tomorrow. We may as well recognize that individuals will not of their own choice save close to half of the income that is available for spending or saving. They are human beings and they will inevitably try to spend more than the value at present prices, of the goods and services that will be available. If consumer incomes are not withdrawn by taxes and borrowing, they will flow to the market in a stream that will break the dam of price control and rationing. When a dam breaks, the floods are not far away."

B. S. CHLEPNER

Capital Levy

AN INSTITUTION involving both the tax system and the public debt is the so-called capital levy, discussed in the following selection: *

Capital levy is a form of taxation designed to appropriate to the state not merely a part of the income from capital but a part of the capital itself. It is always conceived of as an emergency measure, applicable to all capitals above exempted minima, and thus differs from inheritance and estate taxes, which, although they may appropriate a share of the capitals affected, are applicable only to the fraction of all wealth descending by death. Estate and inheritance taxes form a part of the ordinary resources of the treasury, while the capital levy is collected once for all and is intended to be set apart for a specific purpose, usually the sinking of the public debt.

The idea of a capital levy as a device for the abolition or reduction of public debt is not new. Archibald Hutcheson suggested it in his tracts of 1714 and 1717 and later in his *Collection of Treatises Relating to the National Debts and Funds* (London, 1721). Hume ("Of Public Credit," *Political Discourses,* Edinburgh, 1752) rejected it upon grounds of practicability and justice. Ricardo defended the plan in his *Essay on the Funding System* (published in 1820 in the 6th ed. of the *Encyclopaedia Britannica*) and in his parliamentary speeches. It was rejected by J. S. Mill (*Principles of Political Economy,* 1848).

The plan of a capital levy became an object of general discussion after the World War in consequence of the vast increase in public debts. The advocates of the levy may be divided roughly into two groups: those who wished to reduce the debt and thus the interest charges in order that the tax burden might be lightened, and those who wished to free the state from the burden of debt charges in order to allow it to make appropriations for social purposes. The former group, like the early advocates of the capital levy, saw in it a mere capitalization of ordinary taxes. Every capitalist was in effect saddled with the interest on a certain proportion of the debt. He would be no poorer if he cleared off this proportion once for all by surrendering an equivalent part of his capital. The latter group saw in the capital levy a means of redistributing wealth. Most plans for a capital levy provided a certain exemption and applied the principle of progressive

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rates. Usually it was proposed to tax the net wealth of individuals but to exempt corporations.

As a rule the discussion turned on questions of practicability rather than on questions of principle. The fundamental problem was one of methods of payment. Advocates of the levy considered that payment could be made in cash, in public debt certificates or even in other securities. Some foresaw creation by the state of a special financial organ with the function of accepting and liquidating securities or even real estate surrendered in payment of the tax. There were others who proposed that the state should administer these investments instead of realizing on them. This proposal was criticized on the ground that it would represent the beginning of socialism.

Opponents of the levy maintained that enormous difficulties would be encountered in the process of payment. Few taxpayers would be able to pay in cash or in public certificates. Most private capitals, it was pointed out, consist of industrial or bank securities. The treasury could not accept them all. Would it publish a list of accepted securities to which it would thus be giving its official seal? And what would it do then with these securities? If it sold them a tremendous disturbance on the exchange would follow. If the treasury kept the securities it received instead of realizing on them a grave question would arise as to the competence of the bureaucracy to administer such important assets. Finally, many taxpayers had only their particular industrial, agricultural or commercial business. Like the capitalists with securities unacceptable to the treasury they would be obliged to borrow to discharge the tax. Their credit would be inferior to government credit and the interest they would have to pay would exceed the amount of taxes from which they would be relieved by the extinguishing of their proportionate share in the public debt. Moreover, important corporations or large capitalists could discharge the tax more easily than the more modest industrialist, agriculturalist or business man. The effect of the levy would thus be to stimulate economic centralization.

In a number of cases attempts were made to apply the capital levy in practise, but the results were by no means so clear cut as the theoretical conclusions. In Germany the law of December 31, 1919, introduced the *Reichsnotopfer* (emergency sacrifice levy), which was conceived of as an extraordinary tax to amortize the debt and to restore the national finances. All fortunes were taxed; only the sum of 5000 marks for each taxpayer was exempt, like sum for his wife and for each child after the first. The rate was progressive, 10 percent on a capital of 50,000 marks or under, 12 percent on capital between 50,000 and 100,000 marks. It increased gradually until, above 7,000,000 marks, it finally reached 65 percent. These rates were applied to natural persons. For corporations the rate was uniformly 10 percent. The taxpayers who were unable to pay at once could meet their obligations by annuities equivalent to 5 percent of the amount of the tax, plus 1.5 percent for amortization.

The provisions for postponed payments changed completely the spirit of the law. Instead of a capital levy it turned out to be a supplementary income tax. Fortunes were to be appraised as of December 31, 1919, and

the amount of the tax determined on that basis. As a matter of fact, the taxable fortune was almost always less than the real fortune. Industrial plant, for example, was appraised according to its purchase price without considering the depreciation of the mark. As the mark continued to depreciate sharply, assessments, although they were figured in millions, finally represented only a small fraction of the real fortune.

The law of April 8, 1922, introducing the *Vermögenssteuer* (ordinary tax on capital) provided that the *Notopfer* would be levied only up to the amount of 40 percent of the sums due. The rest would be replaced during a certain number of years by special taxes supplementary to the *Vermögenssteuer,* which was to be determined according to fortunes as of December 31, 1922. But in 1923 came the complete collapse of the mark. The evaluation of December 31, 1922, no longer had any significance. The *Vermögenssteuer* was canceled. When it was reorganized in 1925 there was no longer any question of special supplements.

Finally the sums that were collected as a levy on capital were not used to amortize the debt but were simply treated as part of ordinary financial receipts.

A capital levy was instituted in Italy by royal decree of November 24, 1919. All property, whether owned by citizens or aliens (diplomatic agents excepted), was subject to the tax. In consequence of extension of time granted the taxpayers, however, it lost all the characteristics of a true capital levy and was transformed into a supplementary income tax. As in the case of Germany, the receipts from this extraordinary tax, although intended for debt amortization, were treated as part of the ordinary treasury receipts.

The only country in which the capital levy yielded substantial results was Czechoslovakia. Here the circumstances of its introduction were peculiar. To prevent the influx into Czechslovakia of notes which the bank of Vienna continued to issue, the Czech government had undertaken to nationalize its currency. To this end all notes circulating in Czech territory had to be presented for stamping at the beginning of 1919. Half of the notes were retained by the authorities, who delivered in exchange 1 percent forced loan certificates. Half of all deposits in the bank of issue and half of the treasury certificates were likewise commandeered and applied to the forced loan. To amortize this loan and to restore its finances the government by a law of April 22, 1920, introduced a levy on capital applying to all fortunes in excess of 50,000 crowns. The rate began with 4.5 percent and increased slowly to a maximum of 50 percent above 100,000,000 crowns. Payment was to be made in ten or twenty-year periods and time extensions could be granted in certain instances. Property was to be assessed as of January 1, 1920. The yield of the tax had been estimated at 10,000,000,000 to 12,000,000,000 crowns, but the actual yield was about 6,000,000,000, approximately 600,000,000 or 700,000,000 gold francs. Payments were largely effected by means of the forced loan certificates, and the receipts served effectively to amortize the public debt.

Whatever may be said in defense of the principle of the capital levy, it must be admitted that the question generally presents itself from the

practical angle only when the finances of the state are disorganized and currency is in course of depreciation. Such conditions are extremely unfavorable for carrying out a large levy. On the other hand, when finances are running smoothly, when the budget is balanced and the currency stabilized, everyone or nearly everyone shrinks from such an experiment which threatens to destroy a painfully acquired equilibrium.

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ALVIN H. HANSEN

International Loans and Investments

PUBLIC credit frequently crosses international lines and is often mixed with private international borrowing. This involves the many problems of international investment and trade, some of which are suggested in the following selection: *

We may take if for granted that we do not wish to continue gold imports ad infinitum. How, then, do we solve our dilemma? We wish to export more than we import, but how do we get paid? Direct gifts, however humanitarian from a broadly cosmopolitan point of view, are politically impossible, and veiled or concealed gifts once seen through are amusing but impracticable. What about international loans? Must they inevitably wind up in default and therefore in unexpected and involuntary gifts? Must they of necessity create distortions and disequilibrium in the international economy?

These unhappy results did, indeed, in large part prevail with respect to the international loans of the interwar period. But there are several things that may be said about this episode. The foreign loans of the twenties in large part reflected the wild speculative temper of the twenties. The middlemen's profits in marketing the bonds to unsuspecting and credulous investors were not infrequently the primary purpose of the loans. Time and again the loans were made without reference to their economic validity in terms of the uses to which the funds were to be put. The rate of interest was often exorbitant and there were little or no provisions for amortization. If the funds were not used for productive purposes the borrower was in no posi-

* Reprinted from *America's Role in the World Economy* by Alvin H. Hansen, by permission of the publishers, W. W. Norton & Company, Inc., New York. Copyright, 1945, by the publishers. Pages 158–161.

tion to make good on the debt and, moreover, the exorbitant interest rate invited default. The validity of international lending ought not to be judged on the basis of this experience.

With respect to the argument that the impact of international lending upon the world economy must inevitably cause disequilibrium and collapse, again several things need to be said. These consequences are not inevitable. For one thing foreign lending ought to be conducted on a stable basis. At the close of the twenties the vast flow of foreign lending suddenly ceased. Violent fluctuations in capital movements cannot fail to have a disrupting international effect. Foreign lending, if it is to be safe, must be controlled and managed so as to promote international stability; it must not be allowed to cause chaotic and violent fluctuations in international accounts.

Moreover, it should be pointed out that the breakdown of the exchanges after 1929 could not be charged to the burden of servicing the long-term debt. The breakdown was due to the sudden cessation of capital movements and to the rapidly cumulating world depression which created unmanageable gaps in the balance of payment position of the primary-producing and borrowing countries.

Countries can make good on their debt service charges in a stable and prosperous world with an expanding and sustained volume of world trade. They cannot do so in one that suffers such violent fluctuations as we had in the interwar period.

International lending and international investment can be managed in a way to promote (*a*) high levels of employment and production in the great industrial countries, (*b*) rising living standards and productivity in the borrowing countries and (*c*) world-wide economic stability. But the effect of foreign lending may well be disastrous if we rely upon automatic forces. A powerful engine will drive us into the ditch if we do not keep our hand on the throttle and on the steering wheel.

There is every reason why a large volume of international investment and international lending should be undertaken in the next decade or two. From our standpoint international lending affords an outlet for our vast volume of savings. In good years our gross savings, including depreciation and other reserves as well as net savings, are around 20 per cent of our national income—in other words, at $140 billion national income, around $28 billion. It will not be easy to find satisfactory and profitable private-investment outlets for this vast volume of savings within the territory of the United States. Foreign loans and foreign investments can make a contribution to the solution of our savings-investment problem.

On the side of the borrowing countries, they are seriously in need of capital. They could, to be sure, as did Russia in the interwar period, tighten their belts and lower their consumption standards in order to squeeze out of a low national income funds for capital development. But Russia is a totalitarian state. In general, the industrially backward countries with their freer economic system would find this process not only grievously painful but also politically impossible. Foreign loans would greatly ease their problem.

These countries need capital for the development of railroads, roads,

port facilities, electric power and large-scale agricultural projects. On the basis of these developmental projects, agricultural diversification, improved agricultural techniques and industrialization up to a certain point consistent with the resources of the country become feasible. In this manner the productivity, income and purchasing power of these industrially backward countries can be raised. The increase in income and purchasing power will, in turn, reflect itself in a demand for the products which are most in demand in modern, high-standard countries and which the United States is in a peculiarly favorable condition to supply. These include automobiles, electrical appliances, radios, telephones, typewriters and the like. There need be no fear that industrialization of these countries would reduce their trade with the United States and other countries. The multiplicity and variety of products that are demanded as standards of living rise insure a rising volume of trade as these countries advance from lower to higher levels of productivity and purchasing power.

If international loans are undertaken and international investments are managed and controlled so as to insure a reasonably stable flow of capital and if the funds are invested in productive projects, we need not take a pessimistic view with respect to the possibility of repayment. Repayment obviously cannot be made if the foreign exchanges are going to be periodically disrupted by violent fluctuations in capital movements. And particularly they become impossible if the United States continues to experience violent booms and depressions. We do not know how well we shall succeed in maintaining economic stability and full employment in the United States, but it would not be sensible to refrain from a sound program of international lending merely because we are not sure how well we shall manage our own affairs. We must undertake reasonable risks. If we manage our own affairs reasonably well, if we enter into international co-operation on international monetary and financial arrangements, and if the foreign loans are invested in productive and useful projects, then it is reasonable to suppose that over a long-run period the interest and amortization charges can be paid. They will be relatively small in proportion to total international transactions and can quite easily be managed in a reasonably stable and prosperous world. It is only in terms of a rounded view of the whole problem —domestic and international—that a solution can be found. An integrated domestic and international program of expansion and trade would create the conditions under which foreign loans can be serviced and repaid.

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CHAPTER 12

BUDGETS AND FISCAL POLICY

MANY public-finance scholars were trained in the view that their subject was confined to ways and means of providing for public services, plus some passing consideration of these services. Of course, they were always aware that taxes and public expenditures had economic effects, but these were regarded as secondary to the major task of raising revenue according to some canon of justice. With the coming of the great depression of the thirties they began to hear from political leaders and monetary economists that taxation, expenditures, and public-debt management were a principal means of controlling the economy. Indeed, one writer went so far as to say that taxes were not needed to pay the public pay roll—that their sole purpose was to prevent inflation. Thus developed a new area in public finance (closely related to monetary economics) called "fiscal policy."

The old school of public-finance scholars devoted considerable attention to the budget, and they found many technical aspects to examine, such as those relating to "comprehensiveness" in the presentation of budgetary documents. But principal interest in federal budgeting is now associated with the new attempt to make the Bureau of the Budget a planning agency and the budget an instrument for procuring steady and full employment. This leads at once into the zone of "fiscal policy."

Among the subjects of fiscal policy about which endless debate has centered recently are the following: (1) the use of taxation as an incentive or as a means of maintaining purchasing power; (2) the manipulation of public expenditures to compensate for inadequate investment and consumption (either during the off-phase of the business cycle or constantly, as a vitamin for a debilitated economy); and (3) the management of public debt to curb inflation and deflation. To some, a bold fiscal policy is a conservative means of preserving many traditional values; to others, it marks the end of all traditional values and leads only to inflation and ruin.

J. WILNER SUNDELSON

Aspects of Budgetary Procedure

BUDGETARY procedure is a phase of public finance usually classified as a part of a larger division—namely, financial administration. Several of the principles of good budgeting and some of the respects in which budgetary practices differ are outlined in the following selection: *

The Principle of Budgetary Comprehensiveness

To understand the status of any given budgetary balance and to view the budget program as a point of departure for an analysis of the economic implications of a fiscal system, it is most important to examine the extent to which the budgetary procedure and the budgetary accounts include governmental expenditures and receipts. The budgetary system is approached as an instrument of control which may or may not be effective over the entire fiscal system. The concept of comprehensiveness, known also as completeness or universality, describes the relation of the budgetary system to the fiscal activities of the particular governmental unit that it serves. In its usual interpretations the principle presents the demand that the budget cover all receipts and all outlays of the government.[1]

Comprehensiveness is undoubtedly the most widely recognized of budgetary principles, and one that has been recommended as a feature of budgetary policy regardless of the nature of the approach to budgetary matters. Various connections with the principle of budgetary unity established it as the best approach to a study of budgets as financial plans.[2]

From the point of view of political control, it is obvious that the absence of a comprehensive budgetary system defeats some of the objects for which modern budgetary techniques were adopted. Writers like Jèze, who regard budgets as primarily political devices,[3] stress the fact that the relaxation of legislative control or review over a certain phase of a government's fiscal activity, particularly one that is extra-budgetary in character, constitutes a deplorable defect in the system. It should be recalled

[1] Many writers on budgetary problems fail to draw a distinction between the principles of comprehensiveness and unity. In this study unity is defined in terms of segregations, and revenue and expenditure coordination, within the budgetary system.

[2] See: Buck II, *op. cit.*, pp. 125–127; "Budgetary Principles," *op. cit.*, pp. 243–244; Jèze-Neumark, *op. cit.*, pp. 221–22; Neumark, *op. cit.*, pp. 126–162.

[3] Jèze-Neumark, *op. cit.*, Part I, Chap. IV, "Die Politische Bedeutung des Budgets," pp. 38–61.

* *Budgetary Methods in National and State Governments* (Special Report of the State Tax Commission, State of New York, Albany, 1938), pp. 47–54.

that the earliest attempts to institute budgetary systems were related to the efforts to enforce approval by representatives selected by the electorate, of executive action regarding taxation or expenditures. The concept of comprehensiveness has therefore had wide support from students of budgetary problems who have been chiefly concerned with other than the economic and fiscal aspects of the subject.

The problem of budgetary balance and of fiscal efficiency is directly affected by the comprehensiveness of the budget system. The link between a comprehensive budget system and the maintenance of fiscal balance is self-evident since complete equilibrium implies a full measurement of all income and outlay. The identification of budgetary items with a particular period and the frequency of review and voting add a time emphasis to the problem of comprehensiveness. It may be said that in terms of the fiscal problem the question of comprehensiveness assumes real significance. There is little value in seeking balanced relationship between items subject to fluctuating content.

Comprehensiveness does not imply the subjection of all fiscal activities to a similar and uniform budgetary treatment at all times. What is meant is that the existing practice should be known and understood so that it may be relied upon to give a true interpretation of the budgetary balance. Furthermore, changes made during periods in which the budgetary balance is in question must be considered from the point of view of their ability to facilitate and conceal objectionable policies. Certain policies, described below, are not only conducive to fiscal maladjustment but are associated with efforts to mask the true fiscal impact of economic policies. It should be recognized that it is very easy to conceal the increase of expenditures if certain categories may be segregated outside the budget and financed by credit operations not appearing in the publicized scheme of expenditures and revenues. On the other hand numerous infractions of the comprehensiveness norm are in keeping with economic, financial, and political realities. One must without hesitancy deny the usefulness of the principle as a rigid criterion for budgetary policy under all conditions.

In relation to the problem of budgetary equilibrium, the comprehensiveness of a particular budget system must be viewed from many angles. Each aspect affects all the phases of budgetary policy. A questionable attitude towards comprehensiveness may easily create financial disturbances in the planning, adoption, and execution of a fiscal program.

Expenditure Emphasis and Budgetary Comprehensiveness

An important phase of the problem of comprehensiveness, and one that is difficult to measure, grows out of a frequent tendency to consider budgetary techniques as concerned primarily with only one category of fiscal activities. Budgets in many jurisdictions are merely instruments of expenditure control and at only one or two points in the entire system is there any attempt to consider expenditures in relation to the revenues. A fiscal rather than a political or administrative approach to budget problems must be emphasized in order to obviate any tendency to

hamper by the under-emphasis of one feature the coordination of revenues and expenditures.

A stressing of expenditures has, to the best of the writer's knowledge, never been considered as a phase of the problem of budget comprehensiveness. The fact that most of the theoretical and financial discussions of budget problems have not been formulated in terms of American conditions which offer the most striking examples of expenditure stress, may explain this. In any event the recent depression has shown clearly that too many budget systems have been predicated upon an adequacy and stability of revenues and that they have neglected to provide for those procedures that are best suited to the administration of modern financing media. Although here mentioned in connection with comprehensiveness, the difficulties that arise from an emphasis on expenditures can best be appreciated in connection with the various procedural aspects of budget problems presented in subsequent parts of this study.

With reference to practices in the state governments of the United States, it should be noted particularly that emphasis on expenditures and exclusion of revenue items from some phases of the budgetary system place a major obstacle in the path of planning and maintaining balanced budgets. Both in the practice of financial administration and in the study of budgetary problems there exists a notion that budgets are instruments of expenditure control and economy and that revenue problems are distinct.[4] Such an interpretation implies a disregard of the problem of maintaining a balance. It may well account for a large share of the distasteful experience suffered by many state fiscal systems in recent years.

Unless the relationship between income and outgo is kept constantly in the forefront during the formulation, adoption, and execution of a government's fiscal program, a tendency toward uncoordinated and independent action with respect to one or the other side of the budget picture is probable. The result is that the best opportunities for achieving adequate revenue measures are neglected. The most flagrant defect in the various procedures is the disregard of timing. Proper attention to this factor would best facilitate revenue estimating and would encourage orderly legislative consideration of revenue measures designed for adjustability to changing governmental costs. Other ways in which an emphasis on expenditures becomes apparent include a failure to allocate duties and responsibilities for revenue proposals and a disinclination to use budgetary channels in connection with revenue planning. A failure to coordinate

[4] "The notion that budgets deal with, and refer primarily to, expenditures persists in the study and practice of budgeting. The historical evolution of budgetary control with its emphasis on the expenses of the sovereign is no doubt responsible for this. As late as 1917, we are told, 'in the United States and in Europe one thinks of the budget primarily as a document through which a program of expenditures is laid before the appropriating authority.' W. F. Willoughby, W. W. Willoughby and S. M. Lindsay, *The Financial Administration of Great Britain* (New York, 1917), p. 266. The same attitude is even more recently displayed in conjunction with a discussion of the scope of budgetary activity. In a popular text one reads: 'To be properly effective a governmental budget should be comprehensive, it should embrace every item of government expenditure.' W. Schultz, *American Public Finance and Taxation* (New York, 1931), p. 85." (Budgetary Principles, *op. cit.*, p. 243.)

public debt operations with the normal scheme of financing may represent another aspect of the same problem.

There is still evident a belief that the abuses and defects in American fiscal systems, not regulated by established constitutional and statutory practices and for which added administrative norms are needed, are those concerned with expenditures and not with revenues. At the time that budgets were put into effect, the public was faced with problems of pork-barrel raids, waste, dishonesty, and a generally irresponsible attitude towards expenditures. Budgetary estimates were introduced in an effort to control expenditures. The fact that deficit financing, although frequently present, did not act as a major incentive towards the adoption of budgetary practices in the states has already been stressed. For the states, the period following the Civil War was one of almost steady expansion. One needs no clearer indication of the absence of any concern over revenue adequacy and coordination of revenues and expenditures than the fact that the uneconomic and impractical borrowing restrictions of an earlier period did not until recently come in for strong criticism and modification through amendment. One might go so far as to state that even the recent fiscal crises did not bring about a proper realization of the inadequacy of both budgetary mechanisms and debt restrictions. Another explanation of the condition found in the various states is the dominance of the property tax.

The emphasis on expenditures cannot, of course, be absolute; it is at all times relative and difficult of measurement. Every budget system contains some provision for linking the estimates of both income and outgo at the time of presentation of the proposed fiscal program. One finds, however, instances where an initial survey of outlays in relation to financing media is neglected.[5] However, before this stage has been reached there are possible several procedures and practices designed to assure the accuracy and reliability of revenue estimates and to give them the benefit of publicity and control. It is primarily because of a failure to show further concern regarding revenues in relation to expenditures that this feature of the question of comprehensiveness is significant. In Congress and state legislatures it is often the practice to appoint separate committees or sub-committees to deal with revenues, while entirely different groups, acting independently, concern themselves with expenditures. There is little effort at coordinating changes that may affect the balanced relationship of income and outlay, or at timing the introduction of such changes so as to insure the continuance of a balanced relationship. There are in almost all of the states provisions that show an appreciation of the necessity of equilibrium, but the budgetary procedures are not in keeping with the spirit of such provisions.

The budget system of the federal

[5] The following comments show this to be true in the case of Florida. "No provision is made in the budget document for estimating anticipated revenues to meet the proposed expenditures, although the budget law requires such an estimate. There is included, however, a statement of the revenues for each of the two appropriation years next preceding. The budget should contain as much detailed information on estimated anticipated revenues as it does on proposed expenditures." *Report of the Special Committee on Taxation and Public Debt in Florida* (Tallahassee, 1935), p. 27.

government provides for a budget that is primarily an expenditure plan. The basic "United States Budget and Accounting Act of 1921" does not make any attempt to follow the developments in the relationship of revenues to expenditures once the President has submitted his fiscal program to Congress. As indicated above, some of the Congressional committees deal with the budget or other appropriation proposals, while taxes are handled in the House by the Way and Means Committee and in the Senate by the Finance Committee. Both of these committees deal exclusively with revenue proposals. It should be noted that the budget document contains no suggested revenue measures, and that, because of the constitutional prerogative of the House, revenue provisions are not subject to executive control to the same extent as expenditures. In Great Britain, for example, it is not possible for Parliament to haphazardly introduce or vote unrelated expenditure and revenue items. There is no assurance in the British system that a balance will be achieved, but a recognition of the relationship between the factors is insisted upon in the various budgetary stages.

The most pronounced emphasis on expenditures in the budgetary system of a national government is undoubtedly to be found in the United States. To a lesser degree the budgetary systems of Italy and Sweden may be said to display this characteristic. The other national systems seem to place no particular emphasis on either revenue or expenditures although in many cases the systems are not those adapted to a solution of the revenue problems of the country. The disregard of measures best designed to facilitate the financing of budget programs, characteristic of our various state governments, is not duplicated in any national unit.

The process of evolution that led to a basic shift in emphasis first developed in England. Parliament was at one time given only limited authority in the initiation of revenue proposals. This more than anything else describes the extraordinary emphasis on revenue items to be found in the British budgetary system today. If there is criticism, it is aimed at the subordination of expenditure features. Hills and Fellowes, for example, referring to the stress on revenues as a permanent feature of English budgetary practice, point out that British parliamentary procedure pays little attention to expenditures while taxation excites keen interest and controversy.[6]

Features of the British system that explain its superior preoccupation with revenue factors and its marked tendency to discourage disequilibrium between income and outlay include a traditional method of periodic adjustment of tax rates, a marked concern with revenue whenever a new or increased expenditure is advocated, opportunities for the most efficient estimating of revenue, emphasis on revenue measures in the budget statements, and the general unification of revenue and expenditure planning. In connection with every aspect of the budgetary system an opportunity is afforded for discussion of a system better adapted to meet revenue needs.

In regard to receipts arising from public credit operations, the failure

[6] John W. Hills and E. A. Fellowes, *British Government Finance*, (2d ed.; New York, 1932), p. 48.

of budgetary systems to properly coordinate expenditures and financial measures may also be noted. The lack of emphasis on borrowing is justified by the necessity of viewing a mounting debt as an unwelcome omen of deficit financing. The removal of borrowing from the limelight of budgetary procedures is an easy way of facilitating a balance that is achieved at the expense of sound and honest finance. It is virtually impossible to carry on taxing operations in modern society without creating widespread knowledge. However, public debt operations may be obscured or at least withdrawn from a proportionate share of the publicity and emphasis accorded other revenues. In extreme cases the true magnitude of outlays or the insufficiency of tax revenues may be shrouded in secrecy. Although most jurisdictions do not indulge in such flagrant practices, they fail to make proper provision for public debt operations in the planning and adoption of a fiscal program. The peculiar institutions limiting and influencing borrowing in the American states, noted below, are largely responsible for the fact that these jurisdictions do not adequately take public debts into account in their budgetary systems. There are numerous economic and political reasons for considering public debts, as distinguished from other financing media, as in some degree of an extra-budgetary character. However, complete neglect to make some budgetary provision regarding them is of course unwarranted.

In the American states particularly, the depression and attendant fiscal difficulties have revealed a marked emphasis on expenditures in the molding of budgetary practices. Other systems have shown the advantage of granting full recognition to the financial administration of revenue programs. The failure of a particular system to provide adequately either for the revenue phases of its fiscal activities or for coordination with expenditure developments will be noted whenever it is evident in the operation of the system.

Other Aspects of Budgetary Comprehensiveness

Other aspects of budgetary comprehensiveness are discussed in the succeeding chapters. A brief summary of their subject matter may aid in clarifying the scope of the problems discussed as features of this budgetary principle. The following chapter treats with the necessity for adjusting a periodic budgetary mechanism to continuing fiscal activities. The use of the fiscal year for this purpose is familiar. The length of the fiscal periods and their budgetary implications are surveyed as a basis for this view of comprehensiveness. The variations in the length of the budget period in the American states have brought to light a number of reasons for questioning the desirability of maintaining budgetary periods of more than twelve months.

A second feature of the problem of comprehensiveness here analyzed, and one which may be considered in relation to the first, deals with the periodicity of fiscal items. Many elements in governmental finances are not subjected to a review and control corresponding to the recurrence of the budget periods. Budgetary problems raised by continuing tax measures and by continuing and permanent expenditure categories are highly significant in relation to the

question of adjusting fiscal systems to fluctuating economic backgrounds.

A third and final phase is concerned with the existence of extra-budgetary items. This problem of budgetary autonomy must be differentiated from that of variations in the treatment of different items segregated within the budgetary mechanism. The latter problem is to be reviewed in terms of budgetary unity. The segregation of certain fiscal items outside the recognized and normal scope of a budgetary system gives them an extra-budgetary status. They must be studied as a feature of the comprehensiveness problem. Functions allocated to semi-public bodies or to autonomous public and private units are among those that fall within the scope of the principle.

In jurisdictions in which there are wide ramifications of governmental finances and many opportunities for non-tax revenues, the problem of extra-budgetary elements in the fiscal system is important. Particularly the new or transitory policies adopted in response to fiscal and economic disturbances offer possibilities for a breakdown of budgetary comprehensiveness. National governments, with their varied functions and widespread use of public credit and other extraordinary financing media, are frequently found to carry extra-budgetary items. The magnitude of the finances and of the economic resources of such jurisdictions permit the maintenance of activities that are exempted from the requirements to which budgetary items are usually subjected. The irregular character of the links to the budgeted elements of the fiscal system, particularly during periods of financial stress, create serious balancing problems. The concluding chapters of this part deal with national and state provisions and practices with respect to extra-budgetary elements.

Finances of Multiple Jurisdictions and Budgetary Comprehensiveness

No mention is made in this report of the budgetary problems created by the existence of several jurisdictions exercising financial functions in the same geographic territory. Intermediate jurisdictions, such as the American states, must be particularly studied from this point of view since they maintain various fiscal links both with the national unit and with the local communities and other lesser civil units that form their political subdivisions. It has already been pointed out that certain coordination arrangements may aid or retard the various units in their efforts at financial control and stabilization. It falls within the scope of an analysis of budgetary comprehensiveness to point out what portion of the total governmental outlays and income is considered when budgetary equilibrium is measured. National governments are able to shift items to the budgets of the political subdivisions or of their territorial dependencies. At least one European regime has been accused by the political opposition parties of having balanced its budget at the expense of added burdens to be borne by the provinces and the minor civil divisions. The American states have no clear cut or uniform policy of showing in their budgetary accounts the sums that they receive from the federal government. They employ a variety of methods in treating the several types of aid which they render to the localities.

When efforts are made to study

the financial accomplishments and the qualitative budgetary equilibrium of any jurisdiction, status of territorial comprehensiveness and any variations thereof must be taken into consideration. There are American states that pride themselves on having balanced their budgets while they have been obtaining increasingly greater grants than have their neighbors from the federal government. Similarly, there are those that have attained some sort of fiscal balance by reducing the volume of aid in various forms that they give to political subdivisions. New York, which ranks relatively low in the percentage of federal contributions received towards relief costs and which increased its annual contributions to the localities, can successfully meet the standards of other states. The question of the comprehensiveness of its budget program, based on the distribution of burdens between the multiple jurisdictions operating over its area, should, however, be taken into account.

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HAROLD D. SMITH

Fiscal Policy and Budget Operations in War and Peace

IN RECENT years budgeting has become identified with the larger aspects of fiscal and even economic planning. Federal budgeting procedure has been to some extent adapted to this new role. In the following selection a former Director of the Budget discusses the new responsibilities of the bureau which he headed.*

Fiscal policy and fiscal administration have undergone a rapid transformation in recent years. No longer is fiscal administration interpreted narrowly in terms of highly specialized operations of financial control, accounting, and organization. Fiscal administration has become an integral part of government operations —and the principles of public finance and fiscal policy are now viewed in terms of the programs and broad objectives established by the Congress and the President.

Economists, political scientists, management experts, engineers, accountants, and business managers are all concerned with fiscal administration and fiscal policy. The wider concern with fiscal problems reflects,

* Reprinted by permission from Catheryn Seckler-Hudson, *Budgeting: An Instrument of Planning and Management* (Washington, D.C.: American University, 1944), Unit II, pp. 24–30.

in my opinion, the fact that modern economic developments—in war and peace—require a new approach to fiscal policy. Our traditional fiscal institutions, however, have not been fully adapted to the new fiscal necessities. This discrepancy between fiscal necessities and fiscal institutions has created a great number of problems with which we are still struggling. Some progress, however, can be recorded in the effort to develop our fiscal institutions so as to meet the necessities of fiscal policy. Here I shall deal with the development of that part of fiscal administration with which I am most directly concerned, namely, budget operations.

I. *Fiscal Policy in War and Peace*

It is significant that the very concept, "fiscal policy," has only recently come into common usage. Fiscal policy is related to what used to be called public finance, budget policies, government expenditures, revenue, and borrowing. By using the term fiscal policy, we emphasize that all these various fields of government activity must be seen in their interrelationship with each other and also in their interrelationship with economic developments such as national income, consumption, business investments, and other transactions of a domestic and international character. Fiscal policy, it has been said, is public finance guided by consideration of the economic implications of public expenditures, revenue, and borrowing. Fiscal policy in a depression period, for instance, considers the role of government expenditures, taxation, and borrowing in an effort to promote recovery. Fiscal policy during a war period is guided by the role which government expenditures, taxation, and borrowing can play in the mobilized national resources for the war effort. In a period of demobilization fiscal policy again looks at the role which government expenditures, taxation, and borrowing (or debt liquidation) may play in a policy aiming at reconversion and postwar reconstruction. Such an approach to public finance has developed only in recent decades.

As always in the case of new discoveries, there are those who look at the invention as a panacea. There are those who believe that we can assure full and steady employment and avoid all depressions if we only pursue the right fiscal policy. I am convinced that public expenditures, for instance, for agriculture, public works, and social security programs, played an important role in the recovery which was accomplished during the '30's, but I am equally convinced that a fiscal policy designed to accomplish a high and steady level of employment and income must be supplemented by many other measures. Similarly, there are those who believed that by merely pursuing an effective fiscal policy we could overnight smoothly transform the peace economy into a war economy, without need of other wartime controls such as price regulations, rationing, and allocation of raw materials. Here also I am of the opinion that wartime mobilization and wartime economic stabiliization can be accomplished only if government fiscal policies and other measures are integrated into a consistent program.

Those who look at fiscal policy as a panacea err as much as those who some decades ago thought that one could steer the development of the whole economy by an appropriate central bank policy. Equally wrong,

however, are those who fail to recognize that fiscal policy is a most powerful instrument if properly coordinated with all other measures of government policies influencing economic developments.

The development of fiscal policy from a special compartment of government activities into a tool which must be used in close interrelationship with all other tools of governance has been widely recognized in recent years. Insufficient attention, however, has been given to the administrative implications of this fact. Fiscal administration in the Federal Government was in the past largely concerned with highly specialized operations involving improvements in budgeting procedures, efficiency, and economy. A modern fiscal administration, although still vitally concerned with these same things, must do more. It must meet the requirements of a national program established by Congress and the President—requirements which develop out of the complex economic and social trends of our time. From the need of integrating fiscal policies into the national program, there results a new and complex task for legislation and government management.

II. *The Budget Function in Fiscal Administration*

The Budget operation is, in the Federal Government of the United States, a staff service performed for the President and the Congress by the Bureau of the Budget in the Executive Office of the President.

The development of the budget as a tool of fiscal policy may be separated into three phases:

1. The period before 1921 can best be characterized as a period of chaos because the absence of an Executive budget made fiscal programming almost impossible. This lack made itself felt for the Executive as well as the Legislative branch of Government. Departmental expenditure programs were submitted without the benefit of executive coordination. No effort was made to integrate expenditure and revenue recommendations in a consistent fiscal program. Congress had no basis for consideration at one time the government program as a whole. Dispersion of responsibility between the various Congressional committees made coordination impossible.

2. The Budget and Accounting Act of 1921 established an Executive budget, reflecting the growing need for a coherent and cohesive financial policy. The President was obligated by law to submit to the Congress his expenditure estimates and his proposals for taxation and borrowing to finance the proposed expenditures. Congress was to be furnished a financial program formulated by the President with the advice of the Bureau of the Budget. The expenditure program of the Federal Government was presented in its totality, but in this phase the financial measures were still discussed without any real effort being made to integrate the various parts into a comprehensive and consistent national program. It was believed that the government's finances could be operated on the basis of a self-sufficient set of rules bearing little relationship to the economic forces which were rapidly changing the scope and nature of government operations.

3. The Reorganization Act of 1939, shifting the Bureau of the Budget from its location in the Treasury Department to the Executive Office of

the President, recognized the role of expenditures, revenue, and borrowing as part and parcel of the President's program. It is significant that the Executive order flowing from this Act introduced the term "fiscal program" into our laws and recognized the interrelationship of the fiscal program and the general government program by establishing the following functions for the Bureau of the Budget:

a. To assist the President in the preparation of the Budget and the formulation of the fiscal program of the Government.

b. To supervise and control the administration of the Budget.

c. To conduct research in the development of improved plans of administrative management, and to advise the executive departments and agencies of the Government with respect to improved administrative organization and practice.

d. To aid the President to bring about more efficient and economical conduct of Government service.

e. To assist the President by clearing and coordinating departmental advice on proposed legislation and by making recommendations as to Presidential action on legislative enactments, in accordance with past practice.

f. To assist in the consideration and clearance and, where necessary, in the preparation of proposed Executive orders and proclamations, in accordance with the provisions of Executive Order No. 7298 of February 18, 1936.

g. To plan and promote the improvement, development, and coordination of Federal and other statistical services.

h. To keep the President informed of the progress of activities by agencies of the Government with respect to work proposed, work actually initiated, and work completed, together with the relative timing of work between the several agencies of the Government; all to the end that the work programs of the several agencies of the Executive branch of the Government may be coordinated and that the monies appropriated by the Congress may be expended in the most economical manner possible with the least possible overlapping and duplication of effort.

These functions in large part express the breadth and scope of the new fiscal administration. Assistance to the President in preparation of the budget, which reflects the President's fiscal program, is combined in the same staff agency with the development of improved administrative management, advice on legislative enactments and clearance of departmental advice on proposed legislation, progress reporting, and budget administration. These varied activities are focused upon one objective—the attainment of an integrated government program adequate to meet the responsibilities established for the Executive departments by Congress and the President.

Although this paper is confined to one aspect of fiscal administration, it should be mentioned that legislators also have given increased attention recently to the interrelationship between expenditure and revenue programs and between the various

parts of the expenditure programs. The organization of Congressional committees, however, still makes difficult a full consideration of the over-all aspects of the fiscal program. This is a problem outside the scope of the present paper which deserves further exploration.

III. *Development of Budget Operations*

Budget operations during the war have carried forward the development of the new fiscal administration. As a result of the war the budget function was materially expanded in dimension and budget operations accelerated in tempo. The development of budget operations under the Reorganization Act of 1939 was still in its initial stage, and the Bureau was far from equipped for its broadened function when the defense and war program started. There is no doubt that budget operations in many cases fell far short of what was desired and yet they provide evidence of the potentialities of budget management in time of war—and in time of peace.

Conversion of the administrative structure of the government to a war basis was a major aim and activity of the Bureau. The Bureau participated in planning the general organization, particularly with respect to setting up war agencies and defining the scope of their responsibilities; studied government-wide practices of administrative management in order to meet wartime needs; and assisted a number of Federal agencies in solving their wartime administrative problems.

In formulating and presenting to the President recommendations on estimates of appropriations needed to carry on the war activities of the Federal departments and agencies, constant study of the policies and programs and review of their operations in Washington and in the field was necessary. The increasing complexity of the interrelationships between agencies brought about by war activities greatly added to the task of passing intelligently upon their needs for funds.

Budget operations encompass budget execution as well as budget formulation. The main administrative device for the control of budget execution, provided by law, is the apportionment of appropriations. The agencies are requested to submit for Budget approval their plans for distributing the expenditure programs over the year and for establishing reserves to be released only in case of special necessity. The review of apportionments and the control of reserves requires continuous scrutiny of departmental operations, analysis of economic trends, and the development of adequate progress reports of government activities.

Frequently conditions change between the time an appropriation is enacted and the time when the money is obligated and spent. Thus it is frequently possible to execute the Congressional intent with less money than was held necessary at the time the appropriation was made. It was possible, for instance, to reduce expenditures for work relief when unemployment decreased more than was expected as a result of rapidly accelerating defense and war work.

In attempting to secure consistency and coherency in government policies and programs, the Bureau reviews legislation and Executive orders proposed by the various departments and agencies and proposed de-

partmental reports to committees of Congress concerning pending legislation. A major part of this task consists in reconciling divergent views of interested Federal agencies. This procedure serves to provide the committees of Congress with a coherent expression of the Administration's viewpoint without limiting the contact of Congressional committees with the various individual agencies.

The breadth and scope of all these operations requires a constant effort to relate government policies to economic and fiscal trends. With one-half of our national production devoted to the war effort and with government programs affecting so vitally the economic life of the country, budget policy must consider developments in production, in size and distribution of income, in the availability of manpower and materials, and the effects of such measures as rationing, price and wage controls, and credit restrictions. In this task the Bureau of the Budget has cooperated with the special agencies created for the guidance of the war effort, especially with the Office of War Mobilization and the Office of Economic Stabilization.

Cooperative relations with state and local governments have also been developed. Leaders in these governments have recognized explicitly that their fiscal policies can be designed to harmonize local with national objectives. Through their joint organizations they have called upon the Bureau to help translate national programs into state-local policies. Channels are being developed for the reciprocal interchange of experience and opinions. A federal union like the United States has unique need for such channels of intergovernmental communication.

I have given a description of these activities related to budget operations because they illustrate the trend away from the mere scrutiny of requests for appropriations to the function of aiding the President and Congress in the formulation of a comprehensive and consistent government program and to the coordination of government administration and management in execution of the government program.

Besides the examples given above, several other functions could be mentioned which reflect the same trend in day-to-day operations. The Bureau has the function of reviewing all forms and questionnaires used in government statistics; of establishing ceilings for the number of employees employed by individual agencies; of examining war construction projects of Federal agencies; of reviewing public works and improvement programs of Federal agencies; of authorizing publication of periodicals by Federal agencies; and many other activities.

This outline of the recent development in budget operations is evidence, I submit, of the potentialities in the field of general government management in time of peace as well as in time of war.

IV. *The Task of Fiscal Policy in the Postwar Period*

Fiscal policy in the reconversion from a war to a peace economy will again be a task of an intricate nature. The war will leave as a legacy a considerable amount of "backlog" demand of business and individuals, domestic and foreign, for equipment of all kinds. Business as well as individuals will have substantial amounts of liquid funds with which to give effect to their deferred de-

mand for goods and services. There is a real danger of inflationary price pressures in the immediate postwar period. On the other hand, military and economic demobilization will release many millions of men and women from the armed services and war work and will create problems of reemployment and resettlement on a tremendous scale. We may very well face the need for programs designed to control purchasing power and programs supporting reemployment and resettlement at the same time. High postwar demand for inventory accumulation and for making up for deferred purchases will lead to a sustained prosperity only if it will induce a considerable amount of developmental investments at home and abroad. I am confident that we shall have a period of high employment if government programs, tax policies, and credit and international policies are all geared to the needs of economic expansion.

Though I hope that government operations will again be relegated to a secondary role in our economic process, I am convinced that even with government programs on a smaller scale than during the war fiscal policy will remain of key importance in a national and international program designed to assure full use of our resources for peacetime purposes.

The task of perfecting the institutions of fiscal administration and government management to a degree compatible with the role of fiscal policy in the national program will be as important for peace as it is for war. That task is part of our effort to master by democratic processes the problems of our modern world.

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GUNNAR MYRDAL

Budgetary Techniques in Sweden

SWEDEN has achieved a reputation for innovations in budgetary theory and practice. Some of these are discussed by a leading Swedish economist in the following selection: *

Without going further into the theory of business cycle policy, which is being dealt with at this meeting by other speakers, I take it for granted

* "Fiscal Policy in the Business Cycle," *American Economic Review Supplement*, March 1939, pp. 185–193. Reprinted by permission from the American Economic Association, Evanston, Ill.

in the following argument that the general economic reasons for deficit spending during depressions are admittedly good. In addition to the common monetary argument of increasing total demand, there are also important, purely fiscal reasons for concentrating public expenditure in the years when costs are low, and for keeping tax rates at least constant if not decreasing them during depression years.

As I pointed out, the actual realization of this new fiscal policy showed serious shortcomings. In Sweden—where the depression turned into a revival as early as 1933 and where, since 1935, we have had a real boom bringing industrial production 50 per cent higher than the peak in 1929, which, in its turn, was 50 per cent above the peak of 1920—we have, during the last years, been reshaping our fiscal policy in order to avoid these shortcomings the next time. Part of this fiscal preparation for crisis has been to take precautions in order to avoid delay in setting the spending program in motion. An intensive inventory of possible public works in the field of public buildings, road construction, and municipal investments has thus been prepared. A general program for social housing has been worked out in some detail. The state production enterprises—railroads, power plants, post office system, mines, forest preserves, etc.—are urged to prepare yearly building programs for ten years in advance. They are asked to have available at all times technical and economic plans, ready for speedy action. The idea is that next crisis we shall not be caught unawares. The blueprints shall be at hand, the measures shall be decided upon in advance, and the government shall have only to press the button to set the machinery in motion. Meantime, state investment, which had already been planned and decided upon, was stopped during the boom period.

This aspect of the economic planning problem is certainly of the greatest importance. In this paper I am, however, passing it over to devote my main discussion to the reconstruction of the budget system. The shortcomings of the new fiscal policy as it has been tested out in various countries during the last depression are, to a considerable extent, to be explained by the fact that this policy was frustrated as a result of being pressed upon a budgetary system which had been built on principles contradictory to this selfsame policy. It is, therefore, just at present an important problem of economic engineering to construct a new scheme of legal and institutional regulations for the fiscal households: a set of fiscal formulas which at the same time guarantees to a satisfactory degree the "soundness" of public finances in the long run and allows enough flexibility from year to year for fiscal policy to serve its purpose among other measures to mitigate the fluctuations in business activity.

I must here desist from any attempt to discuss the concept of "soundness" of a fiscal system. So much must be said that there is nothing in the fiscal reality corresponding to a conception of absolute financial soundness with the implication that one fiscal system is "sound" and another "unsound." This notion can only be defined in relation to a particular fiscal household, and even then only in a relative sense. We have to make clear what we con-

sider to be assets in a particular fiscal household. The trend of the net aggregate value of these assets minus public debts is, then, the measure of the relative soundness of a fiscal system; if this trend is lowered, the finances are somewhat less sound, and vice versa. The degree of soundness to be kept up in a system of public finances being the basic principle of fiscal policy, it must be established by a political decision. For stability in the system it is of the utmost importance that this principle be fixed and not changed in the short run as a concession to expediency.

It befits an enlightened democracy not only to make this fundamental decision explicit and to stick to it, but to base it not upon abstract stereotypes of definitions and the meaning of the terms, but upon an economic analysis in rational terms of the effects of a choice of one or another degree of soundness: effects on the trend of total capital formation, on income distribution, on the development during future periods of the tension between necessary taxation on the one hand, and possible expenditures on the other hand, and, last but not least, the effects on public confidence.

I want further to stress at the outset that soundness of public finance is a matter of the development in the long run. In principle there cannot exist any contradiction between the two postulated desiderata. Any degree of financial soundness in the long run is compatible with any amount of flexibility of the fiscal policy from year to year.

One of the obvious shortcomings of deficit spending during the last depression was, however, the adverse reaction of business confidence, which has too often restricted or even possibly reversed its stimulating effects. In itself it might seem astonishing that business is apt to react in this way. In a depression with falling demand, decreasing production, and increasing unemployment, there is temporarily a harmony of interests in society. Farmers, workers, businessmen—all should be interested in keeping up incomes, purchasing power, demand, production, employment, and prices.

If business, and public opinion more broadly, is afraid of a deficit spending program it must be because people fear a less sound trend of financial development in the long run. Could we, therefore, make some sort of arrangement giving guarantees for a corresponding overbalancing of the budgets in good times, the public confidence should be satisfied.

That would mean that the budget reaction to changes in business activity should be built on a fixed pattern, regulating deficits and surpluses in budget balancing. It must be admitted that the general public is quite right in feeling its confidence disturbed by rapid, unregularized changes within the field of budget policy, or, to state it in another way, by a fiscal policy which is not integrated and regularized into a system of long-range budget planning, but instead constitutes a break with acknowledged budgetary principles. We must, therefore, not only make a virtue of the sins but also incorporate them in the regular fiscal system in order to avoid the adverse confidence reaction.

The chief technical problem of fiscal policy in the business cycle is, therefore, to design formulas for public finance which, as part of the regular system. make room for deficit

spending during depressions by securing the building up of corresponding surpluses in good years.

When insisting on the construction of a more rigid pattern of budget reaction to the business cycle of this sort, my argument is, however, not only the interest of realizing the chosen degree of soundness in public finances and the interest of preserving public confidence in the fiscal system. My conclusion from our practical experiences in Sweden, and from what I know of experiences gathered in other countries, is also that fiscal policy is rather a clumsy instrument in crisis policy when utilized as the mobile factor in fighting against depressive forces which change from month to month and from week to week. The most we can righteously request from fiscal policy is that it shall in a general and rather rigid way be adjusted to react contrary to the cyclical movements; it is certainly not a good instrument for taking care of the more individualized and concrete troubles of the day or the month. Other means must be found for dealing with them. But this day-to-day policy, broadly monetary policy, will have its way paved if the fiscal policy is built into a strong counter-cycle movement.

Finally, only by integrating the fiscal policy during depressions into a long-range scheme will it be possible to give deficit spending the magnitude actually indicated in the situation. I mentioned that, at least in countries where the Great Depression did not develop into a prolonged stagnation as in this country, the actual deficits have been very small when compared with brave theories—this is at least true of Sweden—and that in no country, as far as I know, has the courage been strong enough to induce a lowering of deflationary taxation; instead tax levies have usually been increased. This is all because the new policy is still in conflict with the basic principles of the budget system. Only by organizing it into a permanent budget system will a more courageous fiscal policy during depressions be possible.

The idea behind such a financial system, in which the budget reaction towards business fluctuations is diverted into a new pattern, more compatible with the desires of business cycle policy, must be not only to take away the irrational inducements to be too parsimonious during depression years, but also to make the budget situation seem difficult in boom years. Deficit spending must be accounted in such a way that it mortgages the otherwise ample resources of good years. The deficits ought, therefore, to be made ostentatiously visible, and a technique must be invented by which the deficits are carried forward until they are liquidated.

That is, of course, the big problem: how to tie the hands of governments and legislators in good times and hinder them from expansion beyond the trend at that time, but to be able to release their hands and spur them to action in depressions. If we want public finance to react as a counter-cycle, we must change the political psychology and give the state plenty of resources in depressions, but hold them back in booms. Such a change in psychology can be carried out by appropriate alterations in the institutional setup. We must, in financial as well as in monetary matters, try to come back to a reasonable degree of automatic reac-

tions. But we must build up these automatic reactions so that they are better adapted to the needs of present-day society. It is not contradictory to ask the legislative body to create for itself, by enacting appropriate rules, new conditions for its own functioning. It is in fact a primitive democracy where the representation does not regularize its own action. The budget system in every country is such a more permanent regulation of the yearly fiscal action. The request is merely to change rules already existing into rules better adapted to their purpose.

After this very general discussion of the problems to be solved, I will continue with a very short description of the new Swedish budgetary system. I hope thus to avoid being too abstract and vague. Among the special conditions prevailing in Sweden at least two ought to be mentioned as of importance to the question of the applicability elsewhere of our new budget technique: after the severe depression Sweden enjoyed a real boom; this unbroken trend of economic development which gives us the right to deal with depressions as temporary setbacks also made it possible for us to redeem rapidly the extraordinary borrowing of the depression years. This, of course, was a more important factor in turning public confidence to modern rational budget principles than whole libraries of books.

We accepted as a start the time-honored idea that the formula for the soundness of public finance should even in future be to preserve intact the present net value of the state's income earning assets, over and above national debt.

We have even accepted—with certain adjustments to be discussed immediately—the equally time-honored financing principle that only profitable, self-liquidating investments could ordinarily be financed out of loans. This financing principle demarcates the capital investment budget. (We now completely separated this capital investment budget from the running budget. In order to make this distinction clear we said that these two budgets should not hereafter be added together to make total budget sums.) There is, indeed, no rational reason for adding together these two budgets; a private entrepreneur or an individual family household would never think of adding together its corresponding accounts.

The running budget contains, on the one hand, receipts from taxation, the yearly profits from productive state enterprises and other yearly state incomes, and, on the other side of the ledger, all sorts of ordinary expenditures which are not of the investment type, plus the writing off of the "productive" investment. The capital investment budget, on the other hand, is regularly financed by borrowed money—in so far as free capital out of sinking funds in the different "productive enterprises" is not available; i.e., in so far as the state is increasing investment over normal reinvestment.

The existence of a separate capital investment budget means, in itself, a considerable amount of regularized flexibility of fiscal policy within the business cycle. On the one hand, the state is free during depressions to expand its investments under this capital investment budget without increasing taxation at the same time. On the other hand, the yearly subtractions from the net profits earned by these investments for payments to

the sinking funds mean the carrying out of an exact long-time balance. As the payments to sinking funds are made automatically and according to technical considerations, this long-time balancing is ordinarily to be considered well guaranteed. There has never been any doubt as to the permissibility of financing profitable investment in railroads, power plants, public utilities, etc., by loans. Financing them by taxation would rather have been considered an unnecessary burdening of the taxpayer.

It is obvious that the greater the proportion of a nation's productive and investment activity carried on in this way, directly by the state, the greater is the flexibility of fiscal policy in the business cycle and the more powerful is fiscal policy as a means of business cycle policy. The chief practical difficulty is that the managers of state enterprises are apt to react very much as managers of private enterprises. The management of state railroads, for example, is naturally most interested in investment when traffic is increasing and actually creating new needs. But the managers of the state enterprises ought to be more easily educated, and, in the last instance, they are under political control, which private investment is not.

Every enlargement of the scope of the capital investment budget will increase fiscal flexibility in the business cycle. With regard to the "soundness" of the financial system in the long run, there is, in theory, absolutely no difference if expenditures are carried over from the running budget to the capital investment budget, provided only that due provisions for sinking funds are established. For many reasons, and especially in view of making the budget principles understandable to the public, which always regards the budget as analogous to private bookkeeping—that this analogy is false does not matter—it seems advisable, however, to keep to the old convention that borrowing is only permissible to finance "productive," self-liquidating investments. But a number of expenditures can easily be made self-liquidating.

Thus, a public corporation, placed on the same level as the other productive enterprises of the state, was instituted to own and administer the state's public buildings, schools, post offices, hospitals, etc. The particular branch of administration has, thus, to pay to this corporation yearly rent for the use of its quarters. This rent is, of course, a yearly and ordinary expenditure on the running budget charged that particular branch of administration. The corporation, in its turn, utilizes its rent incomes for paying not only the upkeep of the buildings, but also interest and depreciation on the invested capital. The payment to the sinking fund is a matter of business routine and follows technical rules. This reform carries with it the added advantage of making the relative costs of different branches of public activity measurable and comparable with much more rationality and accuracy than was possible earlier when the various administrations were charged in the running budget with the costs of new buildings in the year, and only in the year, in which they happened to be built. In the present problem the reform means a greater flexibility in fiscal policy, because during a depression we can now expand our construction program for public buildings and fi-

nance it out of loans without breaking any budget principles and without endangering the soundness of finances in the long run. The burden on the running budget is thus automatically kept upon the same level even for the years when the building program is shrinking.

In the same way we are gradually transferring the social housing program to this capital investment budget in which yearly balancing is not a problem, and in which the long-run balancing of incomes and expenditures is automatically guaranteed by the technical depreciation rules. The state, through another state business corporation, makes loans on strictly business terms to communities and local nonprofit-making corporations and finances those loans from the capital investment budget. The very substantial housing subsidies from the state are kept distinctly separate; they are given in the form of yearly contributions from the running budget to the various local projects.

Nothing stands in the way of transferring the financing of the entire upkeep and construction of roads to another state business corporation. The taxes on automobile traffic are even now reserved for this purpose; these taxes, of course, flow most abundantly during boom years while the building work ought to be concentrated in the depression years. A better timing of investment would, however, be possible by turning over these automobile taxes to a corporation as a regular and guaranteed source of income. If it had these regular incomes this corporation would be able to finance the investment expenditures for new roads building from the capital investment budget. A technically appropriate amount of its yearly income has then to be paid into sinking funds for the depreciation of road capital.

But even with such important changes in the scope of the capital investment budget—which is the best form for an automatic budget structure securing long-range balancing while preserving flexibility from year to year—this capital investment budget will nevertheless be comparatively small. There is, therefore, need for still more flexibility. The method utilized in Sweden during the earlier depression was the usual one: first to conceal the deficit by exhausting certain funds and later when that was no longer possible, to single out certain large items from the ordinary budget—all sorts of unemployment relief, public works of "unproductive" character, and agricultural subsidies—and finance them not out of taxes but by loans. We had, in other words, an emergency budget.

This method is, however, far from ideal. It is irregular; it breaks the budget principles and the budget unity. It further opens the door for certain very irrational influences upon fiscal policy. The minister of finance will, in spite of the extraordinary borrowing for the emergency items, find himself compelled to be most economical on the remainder of the running budget, at the same time as he must take pride in spending on the particular items selected for the extraordinary loan financing. He will further be hindered from decreasing deflationary taxation.

As the distinction between running budget and capital investment budget must be kept fixed and cannot be changed for temporary reasons of expediency, the rational solution must be to give up the old principle that the budget shall be

balanced yearly and to make it a rule that the yearly budget shall be closed by a deficit or a surplus. During a depression a general deficit on the running budget should be allowed as part of the budgetary scheme. But it is then necessary to find the technical guarantees of subsequent overbalancing when the depression is over.

To create this guarantee it is stipulated that a deficit on the running budget shall never disappear from the budget before it is again made good. The deficit is transferred as a negative item to a special budget equalization fund which represents the continuity in public finances. This fund is made self-liquidating by the rule that one year's deficit shall be debited to the ordinary budgets during the next five years by one-fifth each year, that rule providing a maximum amortization term and, of course, not preventing the state from paying off the deficit in a shorter period. There is nothing to hinder a budget deficit during two or more subsequent years, but then the amortization to be paid to the equalization fund piles up. A budget surplus is not allowed to appear on the running budget before all deficits are paid.

In the last instance the guarantee of "sound finances" sought in this budgetary system is the openness with which a deficit is registered, and the institution of the equalization fund by which the deficits are carried forward until they are paid. It is, of course, part of the plan that the budget shall be worked out with scrupulous honesty and that all the customary tricks in traditional budgetary technique shall be forsaken.

This budgetary system makes it possible in the next depression to carry out a much bolder expansionist program without breaking the established budgetary principles. Large increases in investments in the state productive enterprises, in public buildings, in social housing and in roads can be carried out on the capital investment budget and in the ordinary way be financed by loans. The number of "unproductive" public works can also be increased on the running budget, and, which is still more important, there is no need to curtail ordinary expenditures, for the running budget is not supposed to be balanced at such a time. There is, then, for the same reasons, no need to raise taxes; but on the contrary, taxes, or particular varieties of taxes, considered to have deflationary effects may be lowered as part of the depression policy. The burden on the equalization fund will then be progressively increased. In the following boom a revised policy will be enacted by the principles instigated in this institution.

The ordinary maximum height of the equalization fund in a boom is fixed at only about 75 million kronor, which actually means that the normal height over a period of years will be very much under zero. Of course, in the Swedish financial situation in which the state has a capital wealth much in excess of the total national debt, there should have been no difficulty at all in starting the new system by creating a considerable positive fund. When we have, on the contrary, chosen to work with underbalances from bad years to be repaid during good years as the normal course of events, we have followed the pattern of the last depression. We have thought this to be more advantageous, as there is then no limit to the underbalancing

during bad years. If we had constituted a positive fund it is to be expected that it would perhaps be exhausted in the very bottom of a depression, and that a further underbalancing could then (because of that), in a sensitive moment, create bad confidence reactions. It seemed better, therefore, to make a negative fund the normal thing right from the beginning. We thought, also, that the necessity of the repayment of accumulated deficits would be a stronger force toward consolidation during good years than merely the desirability of again building a fund which had been exhausted.

It may be asked: how shall it be ascertained that there is a depression and that a deficit is to be permitted? We have not correlated the working of the system to any specific index of employment or production. On the whole it is not very difficult to know when there is a depression, especially as Sweden obviously reacts to international crisis with a certain time lag. It is, of course, a harder test of economic knowledge and financial character to acknowledge that there is a revival and, therefore, when measures should be taken to strengthen the budget. It is actually in order to build up the character and courage of administrators that the use of the budget system is proposed to correct the accumulated sins of concealed deficits.

Finally, the point might be raised against this structure of fiscal reaction to various fluctuations, that it assumes normal business cycles with good times alternating the bad ones. It may be maintained that the system does not work if the trend should be broken into an economic stagnation interrupted by very short and weak revivals. The answer is that no financial system, and no political system, will long sustain such a development. Economic stagnation calls for perhaps radical changes of the whole institutional structure of an economy, including, of course, its fiscal system, but this reform cannot be carried out simply by fiscal policy. The budgetary system does, however, not exclude underbalancing for any number of years. The only effect will be that the deficits on the ordinary budget will then cumulate into huge sums.

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GEORGE RICHMOND WALKER

Taxes on Hoarding

IN RECENT years much has been heard of "fiscal policy" as an instrument for promoting and stabilizing economic progress. The idea is so to order taxation, public expenditure, public borrowing, budgets, and so forth that the economy will work satisfactorily. Starting with taxation, we may observe first a proposal to force money into circulation by taxing idle savings. This is discussed below: *

I

You remember King Midas, who wished that everything he touched would turn to gold. When he repented of his dreadful wish, he was told that he might jump in the river Pactolus and his "touch of gold" would be washed away. He was lucky. It is not usual that the consequences of excessive greed are so easily escaped.

Have we, the American people, a touch of Midas in our make-up?

Between the years 1934 and 1941 our national stock of gold increased by over fifteen billion dollars. About five billions of the increase was due to an excess of exports over imports, and about six billions was due to the transfer of capital funds from abroad. We Americans willingly exchanged five billion dollars' worth of goods, produced from our own resources and by our own labor, for five billion dollars' worth of gold which we buried in the ground. The six billions of capital funds shipped here as gold were exchanged for deposits in our banks—which could be used to buy six billion dollars' worth of American goods and services—and this gold also was buried in the ground. Apparently we thought we were a smart people to turn our goods and property into gold.

At present we as a people, unable to accumulate gold, are storing away inordinate sums in cash. During the years 1921 to 1930 the amount of currency in circulation never exceeded five billion dollars. A few weeks ago, in December, the amount rose to *over nineteen billion dollars,* or about $145 for every man, woman, and child in the United States, or about $460 each for families and single individuals. That is an altogether amazing sum.

Where is all this money? Nobody knows exactly. But a good deal of it is tucked away in safe-deposit boxes and desk drawers and under the mattress. It was recently revealed, for example, that a former police commissioner of the city of Boston had $35,000 in bills stored away in the

* Reprinted by permission from "The Touch of Midas," *Harper's Magazine,* Feb. 1944, pp. 284–88.

vault of his bank. Cash is more tangible than a bank deposit. Probably some people also appreciate the fact that it is more secret. The amount of your bank deposit is known to your banker, and he may call you up during a bond drive and ask whether you will buy a few war bonds. But currency can be hidden away; nobody knows how much you have or how you got it, not even the Bureau of Internal Revenue.

But it is nice to have money in the bank as well as bills in a strongbox. And our bank deposits too have been growing at a remarkable rate. Back in the boom days of 1929 demand deposits, or checking accounts, totaled about twenty-three billions; they fell to fifteen billions in 1933. But by December, 1943, they had increased (including government deposits) to *about sixty-four billions.* Deposits will continue to increase so long as the government continues to finance the war by means of an expansion of bank credit. And the government will have to go on borrowing from banks so long as it cannot tax and borrow enough from individuals and business concerns. It is not that individuals and business concerns are unable to spare the money necessary to finance the war. They have the money all right, but many of them prefer to hold on to it rather than use it to buy government bonds. The same desire to possess money which made it seem like good business to exchange American products for foreign gold makes it seem like good business to hoard currency and to accumulate money in the bank.

How much of the sixty-four billions held as demand deposits by banks is needed and actually used in financing the nation's business, and how much is in the form of idle balances and excess reserves? Nobody knows precisely, but the amount of "idle" or "surplus" deposits has been estimated to be somewhere in the neighborhood of thirty billions of dollars. The exact sum does not matter; for our present purpose all we need to know is that a good many billions have been withdrawn from active business and put in cold storage.

Why? Why do people prefer to hoard their savings rather than invest them in securities or war bonds? Why are business concerns so anxious to accumulate huge cash reserves? No doubt the reasons are various. But one reason is the illusion that money is wealth, desirable for its own sake, whether it is in the form of gold, paper currency, or bank deposits.

But the more money a man has the richer he is; isn't that true? Yes, it is true of an individual but not of a nation. The Germans did not make themselves rich when, after the last war, they printed untold billions of paper marks. They succeeded only in destroying the value of their currency. Nor are we becoming richer at the present time simply because we are printing more currency and expanding our bank deposits. What we are doing is watering down the purchasing power of our money by increasing its quantity in relation to the things that money will buy. We already have a great deal more money than we need to finance production both for war and for home consumption. And yet the government has to go on increasing our money supply by borrowing from banks—thus creating new money in the form of government deposits—because we as a people are unwilling

to pay enough taxes and buy enough bonds to finance the cost of the war. We would rather hoard money than pay our bills. But is it not foolish to hoard money and to ask the banks to create new money at the same time? It is foolish, and yet that is precisely what we are doing. Some day if inflation hits us we shall look back and see that we were no wiser than Midas.

During the war our hoarding is being offset by the creation of new money which does the work that the hoarded money refuses to do. But money expansion cannot continue after the war without the risk of a Germanic inflation. And so if hoarding continues, the postwar consequence will be economic stagnation: goods unsold, factories closed down, workers out of work.

How can we make hoarding unprofitable?

II

There was a period during the Middle Ages when hoarding was made unprofitable, and the consequences were extraordinary. The three centuries from 1150 to 1450, known as the Age of the Gothic, are described by Sacheverell Sitwell as follows: "It was the greatest period of building activity that there has ever been, and no mere catalogue of names and places can convey any idea of the strength and quality of its products." And again, "There has never been, before or since in history, anything at all like the physical and mental atmosphere of that age. It presented concrete and realized ambition on a scale that has no precedent. Life had turned into poetry; it had changed into a vigorous paradise that made it worth while to run its dangers as well as to enjoy its pleasures." This was the age in which the great Gothic cathedrals were built, the baronial castles, and the guildhalls. Although it was long before the rise of modern science, the industrial revolution, and mass production, prosperity was nevertheless widely diffused among the people. They lacked our modern conveniences and gadgets, to be sure, but even peasants and journeymen were well clothed, well housed, and well fed, and they performed wonders with their hands. The Age of the Gothic seems to have been one of those rare periods in human history when the creative spirit and natural energies of men were set free.

How shall we account for those years of spiritual vigor and material well-being? No single explanation would be sufficient, but there is no doubt that the peculiar money system of the period was an important factor in the astonishing release of human energy. It was a money system which, according to our modern standards, was irrational and unsound. But it worked; indeed, it worked as no money system has worked before that time or since.

What was this system? The coins which came into general use at the beginning of the Gothic period were called bracteates. They were thin metal discs, stamped on one side, and often grooved so that they could be easily broken into halves and quarters when it was desired to make change. They were quite worthless in themselves (like our own paper money) and no one wanted to keep them for the metal they contained. The coins were issued by local rulers, both secular and clerical, and periodically they were recalled and replaced by a new issue. But here is the peculiar feature of the system: in

order to exchange an old coin for a new one you had to pay a reminting charge, or seigniorage fee, of from ten to twenty per cent. This was a lucrative system of taxation for the bishops and the princes, and so they recalled their coins for reminting at least once a year, and sometimes twice a year or even oftener. Thus a person owning one hundred bracteates on the day before reminting day would find himself with only eighty or ninety bracteates on the day after, the prince or the bishop keeping the difference for his own enjoyment. Could any system be more unreasonable and unfair than that?

The system was certainly unfair, but note the results. In the first place no one could hoard money, for coins that were not turned in for reminting became worthless. And second, because the value of money was constantly depreciating as reminting day approached—no one wanted to be caught with money on reminting day if he could avoid it—people had a tremendous urge to spend money as soon as it came into their possession. And it was spent. It was spent for food, clothing, houses, guildhalls, castles, and cathedrals. Money circulated from hand to hand as rapidly as possible, paying for goods and services as it went and calling forth maximum production. All willing workers could find jobs, and all producers had an eager market for their wares. People who wanted to save didn't hide bracteates in a strongbox but spent them on objects of enduring value, such as houses, furniture, and works of art. They became rich not in money but in possessions. And finally, usury was impossible, for there was no profit in accumulating the depreciating bracteates between reminting days in order to lend them out at interest, a fact which made the prohibition of usury by the Church quite superfluous. Thus the Gothic monetary system was hard on moneylenders, but it was wonderful for farmers, tradesmen, artisans, artists, architects, builders, and workers of all kinds.

Let us now compare the primitive money system of the benighted Middle Ages with the highly developed system of our own enlightened day. Our paper money, it is true, has even less intrinsic value than a bracteate, and the modern bank deposit has shed materiality altogether and knows existence only as an entry in the ledger of a bank. But compared with the flimsy and depreciating bracteate, how stable and enduring is our money! You can keep a thousand-dollar bill for years, and no prince will claim a share of it. And you may be sure that the ink in the bank's ledger will not fade. The cost of hiring a safe-deposit box is trifling compared with the value of the paper money it will hold, and the cost of owning a million-dollar deposit in a bank is zero. There are no charges for storage, upkeep, or insurance, and it is not taxed. Never in all history has there been a more perfect medium for hoarding than a bank deposit, not even gold. How inferior therefore were the bracteates! There was little you could do with them except to buy goods, hire workers—and build cathedrals.

The princes of the Gothic Age took a heavy toll when they claimed their percentage on reminting day. And our government also takes a heavy toll when taxes must be paid. But note the difference in the two systems of taxation. They taxed money, and those who held it paid the tax.

We, on the other hand, tax profits, incomes, land, buildings, imports, amusements, club dues, furs, jewelry, and a thousand other things besides. We tax everyone who owns anything or buys anything, everyone who works and earns above a certain minimum, everyone who produces wealth and makes a profit—everyone, in short, except the man who has a million dollars idle in a bank. So long as the million is kept in idleness it is immutable and immune, but once it is sent forth into the world of active business it is harassed by taxation without respite.

The effect of the Gothic system was to penalize money hoarding and to encourage creative labor and production, whereas our system has precisely the opposite effect. Gothic money circulated freely and rapidly, performing its work as a medium of exchange, whereas our money periodically grows sluggish or quits work altogether for weeks and months on end. The bracteate, whose life was short, had to work fast; but dollars, whether in bills or bank accounts, are in no hurry: they are far more durable even than the man who owns them. Thus with bracteates, but without scientific invention and machinery, the people of the Gothic Age enjoyed full employment and prosperity. We, with our marvelous machines and all the benefits of modern science, cling to our durable dollars while factories close down, workers lose their jobs, and people suffer from want and privation!

III

Would it be a good idea to substitute bracteates for dollars in our American economy? Probably not. Our money system, when it is working, is a marvel of convenience and efficiency. The trouble is that we do not always use our money as money is supposed to be used, namely as a medium of exchange. This is largely because of our system of taxation, which favors hoarding and penalizes spending and investing. It would be a very good idea, therefore, to modify our system of taxation. We should tax the man who holds investment funds idle in a bank, and lighten the taxes on those who work and produce. And except for such taxes as those on liquor, tobacco, and gasoline, which serve a special purpose, we should repeal all sales and excise taxes, for these are a burden on commerce. Our money system will work all right when we reform our system of taxation.

But if we put a tax on idle investment funds wouldn't we discourage saving? The answer is that we would discourage only excess saving; that is, saving in excess of the requirements of industry for new capital. The accumulation of surplus investment funds not only serves no useful purpose but is actually detrimental to our economy, for it deprives industry of a market for its products. The sales of industry depend upon consumer expenditure and capital expenditure. In so far as income is saved consumer expenditure is reduced, and unless the savings are promptly spent or invested the sales of industry, and likewise employment, must necessarily decline.

As the investment of capital provides employment and expands the plant and equipment of industry, so the refusal to invest causes unemployment and business stagnation. And yet those who own or control investment funds are allowed to say in effect: "We will spend our money or not as we please. And we will invest

only if we ancitipate a satisfactory profit for ourselves and not otherwise. Any unemployment resulting from our refusal to spend or invest is not our concern."

"But it *is* your concern," we should say in reply. "Having money you have the *power* to buy goods and services, and therefore you are responsible for employment. If you refuse to accept this responsibility it will be assumed by the state, and that will be the end of the system of private enterprise. If you cannot invest at a satisfactory rate of return then you have saved more than industry is willing to borrow at the rate you are asking. You must accept a lower return, just as farmers and manufacturers must reduce their prices if they are above what the market will pay. And if you cannot invest at all, even at zero rate of interest, then you had better spend your money on yachts, or endow a college or a scientific foundation, or give it to charity. In any case, you must not hold your funds idle. Money is the nation's medium of exchange; it is the lifeblood of commerce, the motive force which keeps our economy in operation. If you have money therefore you must use it. We cannot allow you to withdraw it from circulation and hold it idle. We cannot allow anybody to play dog-in-the-manger with the nation's medium of exchange."

The war boom will be over when our enemies go down in defeat. And then what will happen? Investors, apparently, are apprehensive about the future, for with every "peace scare" the stock market goes down. This cannot be very good for the morale of our soldiers: it suggests that those who own American industry, or who have funds available for buying an interest in it, expect that with victory our economy will sink down again into depression.

But a depression need not happen. We shall come out of this war with vast resources, a productive capacity that has no precedent, a larger and better trained labor force than ever before, and a money supply more than ample to finance maximum production and full employment. With these we can have a degree of freedom and a level of prosperity unexampled in the history of the world. How is it that there is even the possibility of failure?

There is this reason: we may find ourselves cursed with the Touch of Midas. We may prefer gold to real wealth, and dollars to the things that dollars will buy. Moved by greed and fear we may hoard our money instead of spending it, and hide our savings instead of investing them. To get money we may sell our stocks and bonds, our land, our buildings, the products of our labor, and when we have the money we may not use it but choose to hold it idle. And then we shall wonder why the farmer cannot sell his produce, why our factories are closed down, and why workers are unemployed.

Some will blame the government and others the system of private enterprise. There will be confusion, bitterness, and recrimination. We shall feel frustrated, cheated, and abused. We shall look for scapegoats. Our fear and our greed will have made us blind to facts and deaf to reason. And we shall not hear the ironic laughter of the gods who granted us our desire to have money. We shall have money. We shall be rich. And we shall be destitute.

Is there no river Pactolus for us to jump in before it is too late?

HAROLD M. GROVES

Ordering the Tax System for Maximum Production and Economic Progress

SOME skepticism about the use of taxation as a goad to desirable economic activity has been expressed by the editor as follows: *

During recent years considerable support has developed for "incentive taxation." This term is used to cover a variety of proposals providing preferred treatment for income from business enterprises and establishing rewards and penalties to stimulate output. Some of the proposals might accomplish their objectives, but in general they do not seem promising for the following reasons:

1. The economic system in its normal operation should generate opportunities and incentives for enterprise. If, under a fair and sensible tax system, it fails to do so, the real causes of difficulty should be sought out and the appropriate remedies applied.[1]

2. A system of bounties and penalties, politically chosen and imposed, is too liable to perversion which can seriously impede the proper functioning of the economy.

3. It is extremely doubtful, to say the least, that business confidence can be fostered by "taxing diffidence."

4. Subsidies for some business are likely to be at the expense of other business—a process resulting in much unfairness and no net gain in initiative.

An economy run by its tax system would indeed be the tail wagging the dog!

[1] Such as reestablishment of balanced international trade and financial relations; agricultural adjustment, both to the domestic and to the world situation; relations of labor and management; maintenance of an effective balance between consumption and productive capacity; and the effective cooperation between government and industry. (This list was suggested in Harold G. Moulton and Karl Schlotterbeck, *Collapse or Boom at the End of the War,* Brookings Institution, Washington, D.C., 1942.)

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WILLIAM H. BEVERIDGE

Selected Passages from Full Employment in a Free Society

THE use of all available tools of fiscal policy to combat unemployment is championed by Sir William Beveridge. Some selections from his own summary of his book on the subject are reproduced below. The book itself is recommended for a more continuous and complete statement.*

5. The proposition that there should always be more vacant jobs than unemployed men means that the labour market should always be a seller's market rather than a buyer's market. For this, on the view of society underlying this Report—that society exists for the individual—there is a decisive reason of principle. The reason is that difficulty in selling labour has consequences of a different order of harmfulness from those associated with difficulty in buying labour. A person who has difficulty in buying the labour that he wants suffers inconvenience or reduction of profits. A person who cannot sell his labour is in effect told that he is of no use. The first difficulty causes annoyance or loss. The other is a personal catastrophe. This difference remains even if an adequate income is provided, by insurance or otherwise, during unemployment; idleness even on an income corrupts; the feeling of not being wanted demoralizes. The difference remains even if most people are unemployed only for relatively short periods. As long as there is any long-term unemployment not obviously due to personal deficiency, anybody who loses his job fears that he may be one of the unlucky ones who will not get another job quickly. The short-term unemployed do not know that they are short-term unemployed till their unemployment is over.

6. The human difference between failing to buy and failing to sell labour is the decisive reason for aiming to make the labour market a seller's rather than a buyer's market. There are other reasons, only slightly less important. One reason is that only if there is work for all is it fair to expect workpeople, individually and collectively in trade unions, to cooperate in making the most of all productive resources, including labour, and to forgo restrictionist practices. Another reason, related to this, is that the character and duration of individual unemployment caused by structural and technical change in industry will depend on the strength of the demand for labour in the new forms required after the change. The greater the pace of the economic machine, the more rapidly will struc-

* Reprinted from *Full Employment in a Free Society* by William H. Beveridge, by permission of the publishers, W. W. Norton & Company, Inc., New York. Copyright, 1945, by the publishers. Pages 18–19; 26; 30–31.

tural unemployment disappear, the less resistance of every kind will there be to progress. Yet another reason is the stimulus to technical advance that is given by shortage of labour. Where men are few, machines are used to save men for what men alone can do. Where labour is cheap it is often wasted in brainless, unassisted toil. The new lands empty of men are the homes of invention and business adventure in peace. Stimulus to labour saving of all kinds is one of the by-products of full employment in war.

* * * *

24. Of the various factors in unemployment named above, deficiency of total demand is the most important. It is true that in one sense there is no demand for labour as a whole because every demand is specific: for a person of a particular quality and sex to do particular work in a particular place. In the same sense, there is no supply of labour as a whole; there are only persons of different sexes, ages and mental and physical capacities, in different places, with varying degrees of specialization and adaptability and varying degrees of attachment to the places in which they are. This is true and the existence of friction in the labour market as a factor in unemployment must never be forgotten. But it is also true that the separate demands for labour in each industry and place at any moment add up to a total which in comparison with the total number of separate persons seeking employment at that moment may be relatively high or relatively low. This relation of total demand to total supply is the most important single element in the problem. It affects the position in every industry, without exception, whatever the special circumstances of the industry may be, because depression in one industry reacts upon other industries in two ways. It reduces directly or indirectly the demand for the products of these industries. It increases the number of people seeking employment in them, in relation to the demand. The excessive pressure during depressions to enter other industries which are least affected by it is amply illustrated by the facts set out in paragraphs 71–3.

* * * *

33. The long-term programme outlined in Part IV covers outlay of all kinds, under each of five heads. There is communal outlay on non-marketable goods and services, including defence, order, free education, a national health service, roads, drains, and other public works. There is public business investment in industries now under public control or which may be brought under it hereafter, increasing the sector of enterprise in which investment can be expanded steadily. There is private business investment; here through a new organ—described as a National Investment Board—the State, while preserving private enterprise, can, by appropriate measures, co-ordinate and steady the activities of business men. There is private consumption outlay—the largest head of the five; this can be both increased and steadied by State action in re-distributing income, by measures of Social Security, and by progressive taxation. There is a new head—described as joint consumption outlay—under which the State takes the initiative by placing collective orders—for food, fuel and perhaps other necessaries—with a view to re-selling them later to private consumers at a price which may

at need be lowered by a subsidy. Under this last head the State can influence both the amount and the nature of private outlay, while still leaving it free.

34. The novelty of the new type of annual Budget will lie in two things: first, that it will be concerned with the income and expenditure of the community as a whole, not only with public finance; second, that it will take the man-power of the country as a datum and plan outlay to that datum rather than by consideration of financial resources. The Minister introducing the Budget, after estimating how much private citizens may be expected to spend on consumption and on investment together under a condition of full employment, must propose public outlay sufficient, with the estimated private outlay, to bring about that condition, that is to say to employ the whole man-power of the country. This is the cardinal principle. It leaves unsettled the question of how the means are provided to meet this outlay—in particular the division between taxation and borrowing—and the question of the purposes to which outlay is directed—including the division between public and private outlay or between consumption and investment. These and other questions are examined in Part IV, where it is shown that there are several alternative routes to full employment. The best route at any time depends on the circumstances of the time.

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H. GORDON HAYES

Spending, Saving, and Employment

ECONOMISTS have shown a growing skepticism for the older view that savings and investments will automatically adjust themselves to maintain or restore full employment. One of the most skeptical is H. Gordon Hayes, some of whose views are presented in the following selection: *

1

The savings-investment process as we practice it leads inevitably to unemployment. It prevents the sale of consumer goods from being sufficient to utilize present producer goods and thus destroys the demand for further investment. This is true because (1) investment results in an increased output of consumer goods

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and (2) investors refuse to buy the share of these goods to which their incomes entitle them, since they wish to increase their savings.

These two propositions hardly need defense, but misunderstanding may be avoided by a hasty survey. In respect to the first one, it is certainly true that both from the point of view of national welfare and of money return to investors, business investments are justified only as they result in an enlargement of the output of consumer goods and services. To be sure, certain investment goods turn out other investment goods—some factories produce machine tools—but this is merely a step toward the production of things to be sold to consumers. It is only when consumers will buy that there is justification in producing intermediate goods.

Further, some investments merely replace previous investments—are of the nature of "repairs and maintenance" and hence do not enlarge output. Similarly some investments are purchases of already existing equipment, as noted earlier, and so do not augment the flow of consumer goods. Investments of these sorts, however, do not contribute to the growth of the national plant. They are very far from what is typically American and are not what anyone has in mind in charting our course. In short, investments must be assumed to enlarge the consumer product.

It should be noted in passing that some savings are invested in the bonds of government units and result in school buildings, roads, and so on, which yield a product that is not sold on the market. We are limiting the discussion at this point, however, to business investments.

The second of the two propositions also expresses a typically American practice—getting ahead. We wish as individuals to grow in wealth. We wish to save, and to save the income from our previous savings. That is, we wish to enjoy the fruits of compound interest.

There are exceptions, of course. Large numbers of persons have incomes that are too small to permit saving and some others simply do not wish to save, but certainly our savers as a class have never reached the limit of their desire to accumulate wealth. Nothing is more a part of the capitalist process than the quest for compound interest.

The argument of this book is then, briefly, that the desire to save prevents the purchase of the consumption goods and services that must be sold if employment is to be maintained. The market impasse to which the savings-investment process brings us may be postponed or avoided during certain lucky periods by the use of various expedients such as sales on credit, exports in excess of imports (net exports), and fortunate inventions. We shall consider these in the following chapter. Suffice it to observe here that all of these expedients merely postpone the market impasse. They cannot enable us to avoid it.

2

Let us assume a "free enterprise" economy such as ours, but small enough so that the relationships that we are considering can be readily seen. We assume an absence of consumer credit either in the form of sales on credit or of loans at financial institutions and an absence of foreign trade. We also assume that there are no monopolies, no trade unions, no taxes and no politics.

There is nothing to hamper business except such conditions as are inherent in business. Let us see what happens.

All of the savings in this community, other than those devoted to repairs and maintenance (which some persons would not call savings), are made, let us assume, by one man, a Mr. Z. His available savings at the beginning of the first year of our observation amount to $2,000 and he loans this sum to a business man who uses it to improve his equipment. The new equipment permits the regular labor force to increase the yearly output by an amount of goods valued at $100. This extra product, plus the customary product, cannot be sold at the usual prices if the amount of money available is not increased. Hence to make the use of the savings as little disturbing as possible, let us assume that a bank extends $100 of credit to the business man on the security of the extra product valued at $100. The business man pays this sum to Z as interest at 5 per cent on the loan of $2,000.

Note that the only changes that take place in this community during this first year as a result of the savings and investment are that the output of goods is increased by the amount of $100 and that Z's money income increases by $100. All other things remain as before. Workmen are not displaced as a result of the new equipment—they merely have better things with which to work. In terms of strict productivity theory Z produces the extra output valued at $100. He might have used his $2,000 in consumption, but chose instead, in effect, to use it to employ labor to produce new equipment and then to use that equipment in turning out an extra product. Z is the only one who has come into possession of extra money, and this is his due.

Thus Z, and only Z, can buy the extra product that has been created, if the customary product that has been produced as usual is to be sold as formerly. If Z will buy the extra product to which he has the money tickets, or will buy an equal quantity of the customary product and let others buy the increment that we are designating as the extra product, all will be well, employment will be maintained.

We may, if you like, think of the product of this community as consisting of a single kind of good, and hence that the only change made is that the product is enlarged by $100 worth of additional but identical units. The significant point is still the same: that Z, and Z alone, has the money with which to buy the addition that has been made to the product as a result of his investment.

Let us assume that Z continues to save $2,000 each year, that this is invested so as to increase output by $100 each year, that Z gets $100 additional income each year as interest, and extends his consumption annually by $100 worth of goods. Z, obviously, consumes an ever larger portion of the total output of the society, but this is merely his reward for abstaining from the consumption of the amount that he saves each year. The significant point is that employment is maintained. Z buys and consumes, or invests in, the share of the total product to which his share of the total income entitles him. All is well in respect to employment.

Suppose now that Z hears about the magic of compound interest and decides to save the income from his

savings. He wishes to save during the ensuing year not only $2,000 as formerly but the additional $100 which he receives during that year. Certainly $100 worth of product cannot then be sold. The only man who has the money to buy it refuses to do so. He wants to save that sum of money. A market glut will have been created.

But, it will be said, if Z could save $2,000 each year without disrupting the economy, surely he can save $2,100 without disrupting it. He could if the business men could count on his then buying the product from the enlarged saving. Business men will not, and cannot, go on piling up equipment if they cannot sell the product. And the product must eventually consist of consumption goods. Failure to buy them as in Z's case creates a market glut. This will mean that the community will have "overproduced." Supply will have outrun demand. Business men will then "take in sail"; they will attempt to get in a liquid position; they will dismiss employees; a depression will settle over the community.

Please note that the many things that are frequently cited as explanations of unemployment are not involved here. There are no "sticky" prices, no exorbitant demands by workers, no taxes that penalize investment, no administration that destroys confidence. Nothing at all has happened to bring sorrow into this garden except an attempt to save at compound interest—a refusal to consume the fruits of previous saving.

If a group of people in the United States build 10 billion dollars' worth of new industrial equipment during a given year and receive a half billion dollars as interest, is it not clear that if this extra income is used to buy the goods and services that are added to the yearly output by the new equipment, or a similar amount of the customary goods, the total enlarged output can be sold, but that if the interest is saved, goods will be left unsold?

Let me state this once again. If a nation has an annual product of 100 units and a national income of 100 units, and if 80 units of the money income are spent and 20 units saved, then a division of the product into 80 units of consumer goods and 20 units of producer goods will permit the market to be cleared and employment to be maintained. In the second year the total output will amount to 101, assuming 5 per cent gain on the 20 units saved and invested the first year. This extra unit of product will normally consist of consumer goods. Thus the product will be divided 81:20 as between the two categories of goods. But the extra unit of money income will accrue as interest to the savers, and they will normally wish to save it. Money income will then be divided 80:21 as between spending and savings, while the corresponding goods are divided 81:20. One unit of goods will not be sold; one unit of money income will not be used. A market impasse will be created—workers will be dismissed.

3

The trouble arises not just because Z or any group of persons attempts to save at compound interest, but because the people of the nation as a whole attempt to augment their money savings. If additions to money savings were made by an entirely new group of persons each year, the result would be the same as if a

given group compound their money savings.

The pioneer farmers could accumulate savings without disturbing the economy. They could grow in wealth without injuring others, for they took their savings in the form of barns, orchards, and livestock. But their descendants are not so fortunate. We cannot save today the food, clothing, and entertainment that we shall want a decade or so hence. If we could do that, we could save without embarrassing one another. But our savings, with minor exceptions, must take the form of money claims, and as I have shown this leads to hoarding and unemployment. To put this in another way, there are limits to the extent to which money will be, or can be borrowed at interest and invested, since the amount that is borrowed reduces the amount left with which to buy the products to be produced with the borrowed money.

If out of a personal income of 100 or a national income of 100 billion, 20 are saved, 80 remain with which to buy consumption goods. If 30 are saved, only 70 remain for consumption; if 40 are saved, 60 remain, and so on. Further, the more that is saved, the larger will be the supply of equipment if the savings are invested. Thus savings cut the profitability of investment with a two-edged sword. They increase the output of consumption goods and reduce the funds available for their purchase. Since the profitability of investments depends solely on the sale of consumption goods and services that are produced with the equipment in which the investment is made, any increase in savings and investment tends to destroy the profitability of investment.

How could there be a more fantastic notion than that the profitability of investment is without limit? America may not be "mature." There may be big opportunities for investment in the years that lie ahead, but these are not unlimited. Aside from the very important factor of the accident of inventions and discoveries, the return from investment depends inversely on the volume of savings and tends to disappear as savings increase. There can be no escape from this. If we all decided to save money by reducing our purchases of clothing to one outfit every three years, what business man would borrow our savings and hire men to make additional looms and sewing machines? Persons already working at such tasks would be dismissed, and in addition most of those engaged in making materials and fabricating finished garments would lose their jobs. Consumption is the key to employment.

To pursue this a little further, how possibly could all of us remain employed at present wages and for present hours if national consumption were reduced 10, 20, or 50 per cent? How, possibly, could we maintain a national income of 120 billion dollars per year and consume only 60 billion dollars' worth of the product? That is, how could we invest half of our national income? How could our business men find it profitable to employ half of all of us workers year after year making equipment with which to produce consumption goods if each of us, on the average, is willing to spend only half of his income on consumption? How, to neglect other items in income, could business men year by year pay out 120 billion dollars in wages, get back only 60 billion by

sales of consumption goods, and then see any profit whatever in borrowing the other 60 billion at interest for the purpose of producing more consumption goods?

Business men cannot borrow money and invest beyond the point at which the resulting output of consumer goods can be sold. And who can doubt that any saving reduces the possibility of selling? That is its essence.

Everything in our economy may be made satisfactory to the business men—taxes, labor relations, government personnel, everything, yet they will not be able to maintain employment as they so earnestly desire to do if we save persistently. Men may declare that private enterprise "can and will provide jobs for all who want them," but the savings-investment process will have its way as inexorably as would the coming of winter in the face of similar incantations that "there can and will be warm weather."

The main idea here is old doctrine to economists. They have always held that so much *could* be saved that the rate of return would fall to zero, but they have thought that this will not happen because they felt that the failure to get a return on savings would cause would-be savers to turn spenders, and thus prevent "oversaving." But as argued in the preceding chapter, this view is no longer acceptable. Every economist today apparently believes that savings *can* outrun investment and lie unused. The argument of this book is that that necessarily happens as savers attempt to augment their savings.

Business men despite their earnest desire to do so have never been able to provide reasonably full employment for more than a few years. Various excuses have always been made for the collapse of prosperity, even when, as in 1929 to 1933, the political climate was and had been all that business men desired. We have steadfastly resisted the conclusion that there is anything inherently wrong in our marketing process. Much of the current talk about post-war employment indicates no appreciation of the difficulty. We may have to learn the hard way.

ABBA P. LERNER

Functional Finance

THE view that taxation should not only be used but used exclusively to control the economy finds purest expression in the work of Abba P. Lerner, from which the following is taken: *

The purpose of taxation is never to raise money but to leave less in the hands of the taxpayer.

The second great prejudice shows itself in the inability to see that taxation should never be imposed merely as a means of raising money for the government on the grounds that the government needs the money. The government can raise all the money it needs by printing it if the raising of the money is the only consideration.

This device is illegal for the private citizen and so it is usually regarded as somehow illegitimate for the government, by the same identification of the government with a private business that makes the government's debt look dangerous and which treats the government's revenue from taxes as equivalent to business earnings and therefore the only really proper source of money for the government to spend. Of course, there are definite limits to the extent to which a government should pay out money (or indeed do anything whatever), but these limits must be defined in terms of the actual effects on the well-being of society and not derived from cloudy analogies with what is prudent and legal for a businessman.

The rational procedure is to judge all actions only by their effect and not by any vague notions of their propriety or impropriety. *"By their fruits shall ye know them."* The effects of a tax are twofold. It increases the money in the hands of the government and, by decreasing the money left in the taxpayer's hands, it makes him spend less. The first effect is unimportant for the government, however important it could be to any citizen to be able to acquire money in this way, because the government can much more easily get the money it wants to have by printing it, without any fear of the police. The important effect is the second, and the question of taxing or not taxing should be governed entirely by whether this effect on spending by the individual taxpayer is desired or not. The effect, which is not easily obtained in any other way, is the basis on which a rational government uses the instrument of taxation. It will tax individuals, or a certain class of individuals, when it believes it to be socially desirable that they should not be so rich or

* From *The Economics of Control,* (New York: The Macmillan Company, 1944), pp. 307–8. By permission of The Macmillan Company, publishers.

should not spend so much. It will tax particular forms of spending (*e.g.*, on whiskey) as a means of decreasing them. It will tax more generally as a means of cutting down total spending when this is necessary to prevent excessive total demand and inflation. Taxation is important *not* as a means of raising money but as a means of cutting down private spending.

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HARLEY L. LUTZ

Functional Finance

VIGOROUS exception to the philosophy of so-called "functional finance" is expressed in the following selection by Harley Lutz: *

Vice is a monster of such frightful mien,
As to be hated, needs but to be seen;
Yet, seen too oft, familiar with her face,
We first endure, then pity, then embrace.

If the term "deficit finance" is substituted for vice in this stanza from Pope's "Essay on Man," a text is provided for this essay. When the Federal deficits began, they were hated. "Too often democracies have been wrecked on the rocks of loose fiscal policy." But in time, the face became familiar. The deficits were endured for a time as a necessary evil, but we apologized for them and promised to end them soon. The next stage was pity, because the national income had not gone up enough to enable us to get rid of the deficits that had been incurred in the effort to boost the national income. In other words, we felt sorry that we could not lift ourselves by the bootstraps.

At last, deficit financing was embraced as a good thing in itself. Any lingering sense of guilt was removed by the fiscal medicine men and "yarb" doctors from abroad and from our own universities who assured us that we were not really living in sin.

The first intimation that what had been mistaken for dissolute fiscal conduct was, in reality, a puritanical standard of fiscal behavior came with the announcement of a new financial philosophy. This new philosophy was given its premier before the Temporary National Economic Committee. Its main tenet is that taxation, spending, and borrowing

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are to be viewed as instruments of policy. The central policy of government is to be such manipulation of the level of prices, the volume of employment, and the flow of income as will serve the aims and purposes of the clique or gang that is doing the manipulating.

Adam Smith disposed of this kind of paternalism in the following: [1]

> What is the species of domestic industry which his capital can employ, and of which the produce is likely to be of the greatest value, every individual, it is evident, can, in his local situation, judge much better than any statesman or lawgiver can do for him. The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.

The changed position of government that this new fiscal theory calls for means nothing less than a transition of political theory from the Anglo-American conception of government as an institution set up to perform certain community services to the Germanic conception of the state as the master. Instead of men being relatively free to take risks, to make mistakes, and to live, as Elbert Hubbard said, so as to be able to look any man in the eye and tell him to go to hell, the people are to be marshaled, regimented, told when to spend, or to lend to the government, or to pay taxes, according to some master plan. Dr. A. P. Lerner put the capstone on this new doctrine in saying that functional finance [2]

> . . . is not especially related to democracy or to private enterprise. It is applicable to a communist society just as well as to a fascist society or a democratic society. . . . Like any other mechanism, Functional Finance will work no matter who pulls the levers. Its relation to democracy and free enterprise consists simply in the fact that if the people who believe in these things (*i.e.* democracy and free enterprise) will not use Functional Finance, they will stand no chance in the long run against others who will.

Germany, Japan, and Italy did lay the groundwork for enormous inflation, but the assets acquired through conquest, together with autocratic control of wages and prices, tended for a time to defer inflation and validate the credit expansion. When these ill-gotten assets are stripped away again, we shall see how flimsy is the real support of their respective debt structures.

The key to this fantastic doctrine is the public debt, which is to be expanded or contracted in the degree required to maintain stability of employment, prices, and production. In a free enterprise economy, the market is the regulator that determines, through the price mechanism, the character and quantity of goods to be produced. The new fiscal theory would replace the market by the public debt as the regulator of economic activity. In Dr. Alvin Hansen's view,[3] private enterprise can produce, but it cannot ensure continuous and sustained demand. He holds that only government can do this, so the result is a kind of co-

[1] *The Wealth of Nations* (Modern Library ed., 1937), p. 423.

[2] "Functional Finance and the Federal Debt," *Social Research*, February 1943, p. 15.

[3] *After the War—Full Employment*, National Resources Planning Board, 1942.

operation in which business produces the goods and government creates the balance of the purchasing power needed to buy them.

The goal is full employment, a subject that has been approached usually in an emotional state bordering on hysteria. In all the discussion that has so far occurred, there has been no reference whatever to the level or rate of wages. If the planners mean that we must henceforth provide full employment at war wages, we can agree at once that this is possible only through a large Federal subsidy. An indefinite increase of the debt and a steady inflation of prices would be inevitable.

On the other hand, if full employment means work for all at such wage as may be determined by equating the supply of labor and the demand for it, we need not be seriously concerned about unemployment even if there should be a depression. The deficits of the 1930's were incurred principally to subsidize wage levels that were unreal and artificial at the time. The housing subsidies are necessary mainly because of high-level wage rigidities and output restrictions in the building trades. A dismissal wage is usually a subsidy to the high wage rates of those who remain on the job. It is clear that there can be no flexibility of prices or of business plans unless there can also be wage flexibility. The new fiscal thesis is the more dangerous because it would use the public debt as the cushion and shock absorber against the rigidities that have been embedded in the economic system by group pressures, special legislation, and the reluctance of everyone to face unpleasant facts.

While the doctrine includes the assumption that the debt will decrease at certain times, the practical result is almost certain to be that there will be no net reduction. Debt retirement requires surplus revenues, and now that the people have learned how pleasant and easy it is to be supported by the government, they are not likely to consent to a curtailment of the bread and circuses just to redeem debt.

The citizens are being conditioned to accept the idea that there is to be no debt reduction by various arguments designed to demonstrate the advantage and beneficence of a large public debt. Hamilton defended the Federal debt, although he was concerned with Federal funding of the Revolutionary War debts rather than with debt for its own sake. Jay Cooke used such arguments during the Civil War. Dr. Hansen has written as follows about the English debt after Napoleon: [4]

> It is difficult to see that the financial and industrial development of England in the nineteenth century could have proceeded with the degree of steadiness and security actually achieved had there been no large public debt available for secure investment.

The view that the English debt was an English blessing was not shared by the statesmen of the nineteenth century, for they were continually struggling with taxes and sinking funds and conversions. Writing of the period 1860–1900, E. L. Hargreaves has said: [5]

> There was a conspicuous failure to take advantage of the great increase in

[4] A. Hansen, *Fiscal Policies and Business Cycles* (New York: W. W. Norton & Company, Inc., 1941), p. 155.

[5] *The National Debt* (New York: Longmans, Green & Company, 1930), p. 199.

wealth which was experienced during the latter half of the century in order to secure the redemption of the greater portion of the debt.

The lack of a more resolute policy was not due to any faith in the great advantages of the debt, although this argument was used by members of Parliament who were unwilling to vote for taxes in sufficient amount to effect the redemption. The advantage of the debt, in providing a field of investment for trustees, was made a cloak for the real resistance to the necessary taxes. The patriotic argument was also brought in. "The Debt and the Empire were indissolubly linked together."

It is curious that the United States should have prospered so mightily during the nineteenth century, having no debt, if a public debt is really an essential condition to prosperity. In fact, in 1837 the Federal government had no debt at all. From 1865 to 1901, the Federal debt was reduced from $2,846 million to $987 million. This action cannot be said to have impaired our economic growth, nor is it true that a much greater debt reduction than actually occurred in England would have retarded the economic development of that country.

* * * *

In the rationalizing about the inflationary and deflationary effects of taxing, spending, and borrowing, there appears to be too great reliance on an oversimplified and hence unrealistic version of the merely quantitative element in the supply of purchasing power. Advocates of the new fiscal theory often speak of the positively inflationary or deflationary effects of particular policies as if given quantitative changes in the volume of bank notes or bank deposit credits would produce definitely measurable and predictable results on prices or business activity. Thus, they say that taxation is deflationary, and bank loans are inflationary, as if these specific results always follow in measurable degree.

In this emphasis the factor of turnover, or velocity of circulation, is neglected. Total purchasing power is a resultant of two elements—actual quantity and turnover. A reduction of the quantity of bank deposits, such as might result from taxation to redeem bonds held by the banks, could be offset by more rapid turnover of the remaining deposits, and there would be no deflation. In the other direction, an increase of bank deposits through government loans could be neutralized by slower turnover, as happened in the early days of pump-priming and devaluation. No inflation would occur.

This is one of the fatal defects of the new fiscal theory. The results aimed at would really require governmental control of both the quantity of money and credit and of their respective turnovers, in order to control the total volume of effective purchasing power.[6] But there is no way of regulating the rate at which the citizens will use or spend their money; hence it becomes necessary that the entire emphasis be placed upon sheer quantitative changes in money and credit supply. This is a false and futile fiscal philosophy that can produce only disastrous results.

The record indicates that the ve-

[6] This is in line with the following plank from the *Communist Manifesto*: "Centralization of credit in the hands of the State, by means of a national bank with State capital and an exclusive monopoly."

locity of circulation has varied widely. This velocity is computed by dividing total debits to individual accounts by the total deposits. The following figures are based on data supplied by reporting member banks: [7]

Year	*Velocity of Circulation*
1929	50
1932	20.6
1934	19.2
1936	21.14
1938	17.78
1940	14.19
1943	19.55

When it is seen that the deficit spending of the 1930's was offset by increasing stagnation of funds, it becomes easier to understand why pump-priming failed. On the other hand, if the velocity rate should now rise to the 1929 level, it is doubtful if any kind of taxation could diminish the quantity fast enough to prevent inflation.

The theory that finance should be used to manipulate the economy has been accepted and elaborated upon by numerous other writers. One of these is Dr. A. P. Lerner whose essay [8] was published last February. Of it Prof. R. M. Haig has written [9] that the reader of Lerner's pages is "torn between admiration for its clear and bold logic and astonishment at the assumptions it considers reasonable and the factors it considers significant."

Dr. Lerner uses the term "functional finance" to describe the so-called principle of judging fiscal measures by the way they work or function in the economy. Two laws of functional finance were stated in the essay under review. The first law is as follows:

It is the responsibility of the government to keep the total rate of spending in the country on goods and services neither greater nor less than that rate which at the current prices would buy all the goods that it is possible to produce.

The following comments are offered on this "law":

1. Even if government wanted to, it could not control the rate of spending since it cannot determine the velocity of circulation. It could regulate the total demand for goods only by drastic rationing, if the demand were keen, or by purchasing all dead stocks, the slow-moving items on all shelves from the department store to the crossroads general store, and all surpluses everywhere not salable at the current prices, if private demand were too sluggish.

2. The so-called law evidently regards the current price level as a bench mark not to be changed, and indeed its unchangeability is important to the whole scheme. Just how much flexibility is to be allowed to individual prices is not indicated, but it must be clear that the quantity of goods which it is possible to produce is governed by the prices at which they can be sold.

3. The volume of goods that it is possible to produce is highly variable, depending, among other things, on the supply of capital and labor, on the number who want to work instead of collect a dole, on the incentives offered to enterprise, on various governmental policies, etc.

[7] Walter E. Spahr, *Why Pump-priming Dollars Have Not Primed,* The National Economy League.

[8] Lerner, *op. cit.*

[9] R. M. Haig, "The Background of Our War Finance: A Rip Van Winkle Survey," *Political Science Quarterly,* September 1943, pp. 321–337, at 333.

Full employment appears to be an important objective, and maximum production is evidently deemed to be reached when all who want to work are engaged. But Lerner is as silent as Hansen about the wages and hours of employment.

In effect, here is a statement of a so-called law which presupposes definite magnitudes, all under control, whereas the fact is that the greatest variety, change, and flexibility are possible and likely. The government is to be responsible for keeping a balance or equilibrium among a vast number of highly sensitive variables. How is this to be done? Dr. Lerner's answer is as follows:

> The government can increase total spending by spending more itself or by reducing taxes so that the taxpayers have more money left to spend. It can reduce total spending by spending less itself or by raising taxes so that taxpayers have less money to spend.

From this the author proceeds to what he regards as a shocking corollary, *viz.,* that taxes should *never* be undertaken merely because the government needs to make money payments, but only when it is desirable that the taxpayers shall have less money to spend, for example, when they would otherwise spend wages to bring about inflation.

This is not shocking. It is merely funny. The author evidently believes, in common with Hansen and others, that quantitative changes in money supply will suffice to determine total purchasing power. He is quite obviously indifferent to the counterbalancing factor of turnover.

Further, he appears to believe that taxation in some way reduces the quantity of purchasing power. Taxation simply results in a transfer of funds to the government. If the government spends the tax receipts, and it must spend if its ordinary operations are to continue, the government employees and pensioners will spend instead of the taxpayers. With no change in the rate of turnover, there is the same amount of purchasing power after as before the tax.

Also, there is involved here the belief, which is held by all advocates of progressive taxation, *viz.,* that the only use made of individual income is to spend it in the market. No allowance appears to be made for the saving and investment of income whereby larger supplies of goods might be produced to meet the increased consumer demand.

Finally, there is an amazing suggestion regarding the chief functions of government. Instead of the services and functions ordinarily thought of as being the reason for the existence of government—police protection, justice, education, regulation, welfare, conservation, etc.—the chief governmental function is to pump money into or out of the economy.

Anyone with imagination and good sense can interpret the effect of this fiscal diastole and systole upon the public personnel, the scope and quality of the public services, and the degree of respect that the citizens would entertain for their government.

The second so-called law of functional finance, as announced by Dr. Lerner, is that the government should borrow money only if it is desirable that the public should have less money and more government bonds. He adds that this might be desirable if otherwise the rate of interest would be reduced too low and induce too much investment, thus bringing about inflation.

This proposition also requires comment.

1. Who is to decide between the desirability of bonds versus money in the hands of the people? It has already been proposed that when the people are deemed to have too much money, their taxes are to be raised. Perhaps the Office of Price Administration, in view of its distinguished record in point-rationing, could be asked to fix the point values of government bonds along with those for gasoline and tomato soup.

2. Suppose that the people prefer money to more government bonds. Does this mean resort to the technique so successfully used by Hitler, Mussolini, and Franco in confiscating the forms of private wealth which they did not want the people to own?

3. What is the evidence to show an increase in the volume of investment with a decline in the rate of interest?

4. When did overinvestment produce inflation? Perhaps the author is thinking of stock market speculation. When the term investment is correctly used it means an application of funds which results in additions to capital equipment and productive capacity. Such additions, by increasing the output of goods and services, tend to prevent inflationary price increases.

It is said that functional finance rejects completely the traditional doctrines of "sound finance" and the principle of trying to balance the budget in any year or any arbitrary period. Under the taxing, spending, borrowing, and lending policies advocated, any excess of money outlays over money receipts must be met, it is said, by printing new money. Resort to the bank loan or to the printing press will not cause inflation under this theory because the excess money can be pulled in by taxation and destroyed or hoarded.

That is, at one time the government is to withdraw from private hands through taxation or borrowing more than it pays out on its ordinary services and for interest, thus supposedly reducing the capacity of the people to spend. At another time the government is to pay out more than it takes in. The excess withdrawals can be destroyed if they consist of paper money. If they consist of bank deposits, the effect is a decline of taxpayer balances and a rise of government balances in the banks.

The sole purpose of this pumping is to regulate the rate of spending, but as already pointed out, it is possible that counterbalancing tendencies in the velocity of circulation may neutralize the work of the pump.

The Swedish idea of a cyclical budget balance is rejected because of the lack of any guarantee that the maintenance of prosperity would permit the budget to be balanced even over larger periods (*i.e.,* than the business cycle). So Dr. Lerner is forced to recognize that the result might be a continually increasing national debt, if the additional spending were provided by borrowing the money from individuals or banks instead of printing it.

But this would present no danger to society, in Dr. Lerner's opinion, as long as functional finance maintained the proper level of total demand for current output. As for the interest, it can be paid, he says, by borrowing still more.

It is time to pause again for some comments. Although the possibility

is assumed that the budget may be indefinitely unbalanced, one wonders just what significance a Federal budget would have in a system in which the chief governmental function is that of pumping money into or out of the economic machine.

Further, the paradoxical result is obtained that no inflation would ensue from an indefinite period of budgetary deficits caused by pumping out purchasing power with little or no retirement through taxation. For this to be true, inflation would be staved off only because of the decline of velocity toward zero. But a declining turnover rate is usually indicative of caution, uncertainty, a preference for cash rather than goods, unreadiness to take risks, etc. Under such conditions, production tends to decline and employment to fall off, despite pump-priming.

Again, from whom will government borrow the money to pay interest? As long as the public is willing to lend, it is said to make no difference how many zeros are added to the national debt. If the public loses its taste for lending to the government and hoards its money, the government, it is said, can print the money to pay interest and other public obligations. It is evidently assumed that the people will gladly accept this printing-press money. But suppose they will not. Are they to be forced to take it? And at what value? If the bondholder is compelled to take it at par for interest, on what terms can he dispose of it in buying the products or the services of other individuals? Dr. Lerner would probably say that any depreciation of the currency would indicate inflation and would be the signal to begin taxing. But if this depreciation should occur before full employment is reached, then he would have an inflation to deal with while still facing the need to increase spending.

But an alternative supposition is offered, *viz.*, that the people, being unwilling to lend to the government, elect to spend instead of hoard their money. Private spending will then increase the total spending, and the government will not have to borrow for this purpose. If private spending goes too far, taxation must be used to prevent inflation. The proceeds can then be used to pay interest and repay government debt.

Note, however, that government disbursement of the tax receipts in debt service payments would put them right back into circulation again, and so the aim of inflation control through taxation would be defeated.

It hardly need be pointed out that this scheme will not work under either assumption. If the people hoard instead of spend, or if velocity of circulation declines so as to lessen total buying, the government must begin to pump money in, and there is no way to prevent the currency from depreciating while some persons are still out of work. On the other hand, if the people spend freely and taxes are imposed, the government must severely restrict its spending in order to check the inflation. According to the degree of this restriction, there would be disorganization of the public services and demoralization of the public personnel.

Nothing is said about the kinds of taxes to be used, if and when the rules of functional finance should indicate that taxes are to be levied. If the pattern of income distribution were to be anything like that now prevailing, the bulk of the taxes

would have to fall on the incomes under $5,000 in order to be of maximum effectiveness in inflation control through restraint of spending. Nor is anything said about the kind of index that would be used to show the onset of inflation, and thus to give the signal for taxation to begin. The Bureau of Labor index is under fire now from the CIO. We can only imagine the outcry that would meet any official notice to the effect that, beginning tomorrow, taxes must be paid because inflation had started.

The author of functional finance is evidently thinking in terms of a Federal government only, although he makes no distinction in saying that taxes must not be levied. What would happen to state and local governments in those periods when taxation was out of season is not even hinted at. These governments have no present authority to print money, and no power to force investors to take their bonds. Yet their annual tax bill totals $8 to $10 billion.

In this fantastic program, the terms "tax" and "taxation" should not be used, for they mean and connote an attitude by government toward the resources of the people which has entirely disappeared in Dr. Lerner's plan. If we no longer intend, by the word "tax," to mean contributions collected to defray the cost of public services, then we should find a new term to describe what is proposed. An appropriate one is "confiscation."

Likewise, the word "bond" should be dropped, for that word has always meant a pledge or promise to repay a certain value in future in exchange for a given value obtained today. If the term "forced loan" were substituted, it would seem more appropriate to pay the interest on such a loan by compelling the holder to accept fiat currency, which is simply another form of the forced loan.

One thing that the scheme lacks is a parallel to OPA, which should be called OMA, or Office of Money Administration. Its function would be to curb the black market that would emerge in the phony printing-press money, where people were trying to get rid of it for less than its face value.

One of the gravest perils of the postwar period will be those planners who are either ignorant of or indifferent to history. There is little reason to fear the adoption of functional finance even though our ultimate downfall is forecast before some rival nation that has discovered what it thinks is bootstrap levitation. We do have to remember that there is a hard way as well as an easy way to solve our problems, and that the hard way is very likely to be the safe way. If the abuse of public credit and the printing press is really as safe as it appears to be easy, there would be no occasion to emphasize such historical phenomena as the Continental currency, the French assignats, the United States greenbacks, or the German reichsmark. All schemes for fiscal Utopia overlook the one basic fact about the kind of economic world we live in —"There is no free lunch." This fact is as applicable to a socialistic or communistic society as it is to a democracy.

GEORGE TERBORGH

The Bogey of Economic Maturity

IN SOME of the earlier selections in this book the view has been expressed that our economy is undergoing secular changes which make it more and more difficult to maintain full employment. The author of the following takes sharp exception to this view: *

We observed at the beginning of this study that the theory of economic maturity had its origin as an explanation of the great depression of the thirties. Save for this calamity it probably would never have been heard of; certainly it would never have gained a fraction of its present currency. As we indicated in the preceding chapter, nothing in the history of this country prior to 1930 lends the theory either weight or color; indeed its application to the pre-depression period is almost grotesque. It is of crucial importance, therefore, to ask whether the collapse of 1929–32 and the halting recovery that followed may be justly attributed to economic maturity.

Secular Causes for a Cyclical Decline

The first thing that strikes the eye is the extraordinary incongruity between cause and effect in the stagnationist theory of the depression. In explaining a cyclical movement, sudden and cataclysmic, like the decline of 1929–32, it invokes secular changes so slow and gradual as to be imperceptible within the span of a cyclical disturbance, changes moreover which had been going on with no visibly baneful consequences for decades. We are asked to believe that somehow these formerly benign secular developments were suddenly transformed in 1929 into malignant and dynamic cyclical forces. Dr. Jekyll became Mr. Hyde.

The four horsemen of the stagnationist apocalypse have been reviewed in the preceding chapters: the decline of population growth, the passing of the frontier, the dearth of great new industries, and the increasing financial self-sufficiency of corporations. Let us relate them to the debacle of 1929. To attribute this collapse to the passing of the frontier forty years earlier is sheer mysticism. Neither can it be ascribed, as we have seen, to the alleged tendency of corporations toward internal financing. No credible evidence of such a tendency has been adduced. As for the dearth of great new industries, why was this suddenly manifested in 1929, without warning, on the heels of a vigorous investment boom? Surely the rich

* Reprinted by permission from *The Bogey of Economic Maturity* (Chicago: Machinery and Allied Products Institute, 1945), pp. 173–176; 190.

and varied technological progress of the twenties did not abruptly reach a stalemate at that point. Even if it had done so, this would not have been a manifestation of economic maturity, but rather—by the admission of the stagnationists themselves—an unrelated phenomenon. Declining population growth? Changes in demographic growth rates are glacial in movement. Why should a trend that had proceeded harmlessly for three quarters of a century suddenly turn malignant in 1929?

Since this is no place for an excursion into business cycle theory, we shall merely state our view that the decline of 1929–32 reflected an acute, not a chronic, disease of the economy, resembling an attack of pneumonia, in contrast, let us say, to diabetes. Its causes were cyclical causes, in new combinations and proportions to be sure, but fundamentally the same that have appeared so often before. True, the decline was of unprecedented gravity, but this can be explained without invoking the four horsemen of economic maturity. Indeed it *must* be so explained, for the simple reason that the four horsemen are of little or no use for the purpose.

It is a fundamental error to assume that the gravity of a depression is necessarily a reliable measure of the scope and importance of the "maladjustments" which initiated the movement. A downswing tends to become a self-aggravating phenomenon, and given a few unlucky "breaks" in the evolution of events, including inexpert handling by government, it can expand to proportions out of all relation to the magnitude of its original causes. Whether it bottoms after a moderate recession or continues downward may depend at various points along the route on comparatively small differences in the pattern of events. In other words, the balance of constructive and destructive forces may frequently be close. Just why in one case the turn is achieved after a moderate decline, while in another the slide continues, may be obscure. Why a man contracts pneumonia at one time and only influenza at another may also be obscure. In neither case, however, is it necessary to postulate a basic constitutional degeneration to account for the difference.

Without going into an extended discussion of the original causes of the depression, which would take us far afield, we can say merely that they did not foreshadow a catastrophe of such unprecedented magnitude. Especially is this true of the cause to which the stagnationists assign such a pre-eminent role, the relative exhaustion of "investment opportunity." Since they give almost exclusive attention to this factor, so central to their theory, it is worthwhile to look at it further.

Was there a relative exhaustion of investment opportunity in 1929? The answer depends on how this term is defined. If we mean only that certain major lines of investment had been temporarily overdone and were due for a period of digestion at a somewhat reduced rate of activity, we can say yes. If we mean that the recessive tendency in these lines temporarily overbalanced the expansive tendency in other areas of capital formation, we can also say yes. To take the most important area of weakness, there is no doubt that in 1929 we were entering the soft phase of the building cycle. The volume of residential construction had been declining for some time. The boom

in large apartments, hotels, and skyscraper office buildings had apparently passed its peak. These declining tendencies in building construction were offset during the early part of the year by soaring activity in certain other lines—for example industrial equipment and passenger automobiles—but this offset could not last indefinitely. It seems evident that we were due for a period of relative weakness in capital formation as a whole while the building cycle went through its digestive phase.

The real question is whether this state of affairs represented something new in history, requiring a new explanation in terms of economic maturity, or was merely a recurrence of a long-established cyclical pattern. It seems clearly the latter. The tendency for building booms to outrun themselves and to require a period of correction is as old as the record.

* * * *

Conclusion

The great depression of the thirties, so crucially important for the theory of economic maturity, lends it [the stagnation theory] little support. The attempt to explain such a sudden cyclical collapse by reference to gradual secular developments of long standing strains credulity, so much so indeed that the stagnationists have felt the need to bolster their diagnosis of the debacle mainly on ordinary cyclical factors unrelated to economic maturity. While the slowing up of demographic and territorial expansion fails to account for the decline of 1929–32, it fails even more signally to explain the halting recovery of the late thirties, when the growth of population and the march of invention had created quite exceptional "investment opportunity" from a physical and technical standpoint. As for "oversaving" or "underinvestment" as an explanation of the depression, these are question-begging words without causal significance. Finally, it would take 20 to 50 years to prove that the depression was really the onset of secular stagnation, and heaven knows how long to prove (if it could be proved at all) that the stagnation —and hence the depression—was due to economic maturity. This project should assure full employment for generations of stagnationists regardless of whether their theory is right or wrong.

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CHAPTER 13

CONCLUSION

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ROY BLOUGH

Conflict and Harmony in Taxation

PUBLIC finance is a highly controversial subject involving not only a conflict of views but also a conflict of interests. Lest the reader leave the subject with the impression that nothing but conflict exists in this field, the following is presented: *

Taxation is an instrument of organized society. Itself a social institution or group of institutions in the broad sense, taxation exists for the service and promotion of other institutions; in and of itself it produces no personal or social utility. Accordingly, the system of taxation rests on the political, economic and social structure and should be fitted to that structure and adapted to achieving the ends and objectives of the society. Such adaptation does occur, although sometimes belatedly. Thus the general property tax served an undeveloped agrarian America but decayed with the rise to dominance of commerce, industry and finance. A very current example is presented by Soviet Russia. As long as Soviet Russia followed a policy of equality of incomes, it used the sales tax almost exclusively, but in recent years when a policy of unequal incomes has been increasingly accepted, the progressive income tax has been adopted.

But taxation is no passive instrument. It exerts an active force of such strength that it inevitably affects the social structure and may importantly alter the course of social evolution. Annual wartime tax collections of $50 billion—virtually as much as the total national income during the depths of the depression

* From an address before the American Philosophical Society, Philadelphia, February 18, 1944.

—cannot avoid having a major impact on social and economic life. Postwar peacetime taxes will no doubt be substantially lower than wartime taxes, but they can scarcely avoid being so high as to contain an important key to the production and distribution of wealth and income. The effects of such taxation cannot be kept neutral. The potency of taxation is so great that it may be and indeed continually is used as an instrument for making changes which politically dominant groups believe should be made in the social structure. The first Federal revenue act, that of 1789, was for the promotion and protection of industry as well as for the raising of revenue.

Accordingly tax policy is not something to be considered as a separate, independent subject. It is an integral part of general social and economic policy. Likewise the study of tax policy should not be approached from only one side, such as economics. Adequate consideration of tax policy involves, in addition, ethics, law, political science, sociology,—indeed every point of view from which the social structure may be studied.

* * * *

Conflict of Interests

In taxation conflicting interests are very powerful. Evidence of the existence of tax conflict is inescapable to all who may observe the intense differences of tax opinion, the contradictory tax programs of different groups and even so small an item as the amount of Washington hotel space pre-empted by tax lobbyists. To those in position to follow closely the policy-making process, evidences of conflict are often very painfully clear.

The reasons for the strength of conflict in taxation are fairly obvious. Broadly speaking there is harmony of economic interests in the achievement of maximum production and there is conflict of economic interests in distributing the product among those who joined forces in the productive process. Taxation is part of the process of distribution—of what is commonly referred to as secondary distribution.

Conflicting interests are stronger in taxation than in most aspects of distribution because in taxation there is little or no relation between the amount of taxes a person pays and the amount of benefits he may derive from Government. If a person is able through a change in law to transfer part of his burden of taxation to the backs of others, there is no resulting loss to him in the form of a reduction of governmental services. Moreover, the tax bargain, if it may be so designated, is in the political field and there are no economic acts of the individual whereby he can affect the amount of his burdens by withholding goods or services from the market. This applies, of course, to the first impact of the tax; he can to some extent affect the subsequent shifting and incidence of the tax; but it is in the political field that the conflict principally appears.

Major conflicts of interest over tax policy arise primarily because persons are in different economic positions or different geographical jurisdictions. Perhaps the most important economic difference is that based on the volume of wealth or income, which is reflected in the conflict of interests over the progressiveness of taxation. The change in three decades from the regressive Federal taxation of pre-income tax days to the highly progressive income taxes of

today was highlighted by many struggles.

While the emphasis in tax discussions has been largely on differences in the amount of wealth or income, other economic differences also give rise to conflicts of interest over tax policy. Thus, there are differences in the source of income: a person may derive income from property alone or from personal effort alone, or from various proportions of property and effort. There are differences in the occupation and the industry from which income is derived. Differences are likewise present in the forms of wealth, especially between tangible and intangible property. Other differences concern the disposition of income between consumption and savings, among various kinds of investments and among various types of expenditure.

Conflicts of interest in taxation arise also from geographical differences, that is, differences in the political jurisdictions in which people live. Responsibility for financing the activities of government is divided among some 175,000 jurisdictions. All persons living within any one political jurisdiction have some interests in common which conflict with the interests of persons in other jurisdictions.

An individual is not limited to only one interest. He always has at the same time several kinds of economic and geographical interests, each in common with various other individuals. Thus a manufacturer who has an additional income from corporate stocks and owns his own home has certain interests in common with real property owners in general, certain other interests in common with manufacturers, others with owners of securities, others with the corporations in which the stocks represent equity, and still others with consumers in general. He also has interests in common with other persons in the same political jurisdictions—city, county and state—regardless of the relative economic situation of these persons. His interests and outlook are thus not unitary; he is drawn in opposite directions by his competing interests. In taking an intelligently selfish stand on questions of tax policy, his position will depend on the evaluation that he makes of his competing interests. Relative values of these interests to him may change from time to time, thus changing his attitude toward tax policies.

This conflict within each individual prevents the tax struggle from being a clear-cut fight with every person permanently lined up on one side or another. In many kinds of tax questions, the balance of interests will be so close that a large number of individuals will be relatively neutral. This group of neutrals often holds the balance of power between conflicting groups and this is, for practical purposes, the public. Although the true public is commonly at least a majority of the people, the effective public in any tax conflict is this group of relatively neutral persons. The composition of the effective public group may change with each succeeding tax issue.

Although no two persons are likely to have the same pattern of economic and geographical interests except by accident, there are degrees of similarity and contrast. Since political power largely determines tax policy, persons with like interests tend to form groups for the more effective expression of their opinion. These groups have varying degrees

of effectiveness in dealing with the makers of tax policy, but in general have a great advantage over persons not working through group organizations. On the geographical side, unity and conflict of interest are formally recognized in the system of representative government under which representation is based on geographical districts.

Harmony of Interests

The spectacular nature of conflicting interests in taxation tends to obscure the presence of harmony of interests. Some harmonies are direct and obvious. Nearly everyone prefers certainty to uncertainty and confusion in the amount of his taxes. Nearly everyone is benefited by a low cost of tax administration and low cost of compliance.

Other harmonies underlie apparent conflict or at any rate set limits to the conflict. For example, a high protective tariff on manufactured products might so destroy the foreign markets of domestic farmers and diminish their purchasing power as to affect adversely the markets of manufacturers with the result that the manufacturers would really be better off with lower tariffs. In this case there is an area of conflict between farmers and manufacturers but beyond a certain point the conflict may be replaced by harmony, since both may benefit from the same policy.

Another type of basic harmony is inherent in the concept of tax justice. Although what is just is a matter of opinion there is a good deal of agreement over large areas. Justice is a moral end or objective and its violation outrages the moral sense of people. Moreover, good-will among various groups in society is necessary to the effective functioning of economic organization. Flagrant injustice in taxation destroys good-will and leads to destructive antagonisms. Taxes imposed by the political power of one group may so destroy the good-will of other groups that the harm from the resulting non-cooperation more than wipes out the advantage to the apparent beneficiary. Some superficial advantages that an individual or group might obtain by political force always must be sacrificed in order that there may be peaceful and orderly political, social and economic relations through which greater advantage for all may be secured.

Still another kind of harmony is based on the interest which the members of a group seek not each for himself but each for the whole group. Such group loyalties or common interests usually arise when the group is in conflict or in competition with other groups and the loyalties tend to disappear in the absence of such conflicts or competition. For the nation as a whole this kind of harmony in taxation has proved difficult to achieve even during time of war when national unity is greatest.

Conflict, Harmony and Tax Issues

Problems of forming tax policy take the form of tax issues. These issues involve the decision among alternative courses of action with regard to any of a large variety of tax questions such as the total amount of taxes, the types of taxes to be employed, the relative emphasis on each type, rate schedules, and exemptions, as well as percentage depletion, basis for gain and loss, invested capital credit, contemplation of death, pay-as-you-go, floor-stocks tax, definition of proof gallon,

powers of appointment, withholding certificate, postwar credit for the Victory tax, carryback of losses, and so on.

The absence of a tax issue in a certain area does not necessarily mean that no conflict of interest is present. Tax issues do not ordinarily arise if there is only a very small minority whose interests are opposed to those of a large majority. In such a case, the decision is taken for granted and no problem is recognized. The minority feels its helplessness and does not even bother to raise the issue. The possibility of favorable action may be so remote that they do not even think about or recognize their own interests. Issues come to the foreground only when opposing groups are of substantial size.

Tax conflicts may present themselves in various forms. Two group interests may be pitted against each other, or one group interest may be pitted against the combined opposition of several other groups, or one group may be struggling against the inertia and passive resistance of the remaining groups. There need not necessarily be an apparent, direct clash between groups. The issue is perhaps more likely to take the form of one group demanding that its taxes be lowered or not raised as the case may be. Representatives of such a group commonly say they have no desire to increase the tax burdens of anyone else. This is no doubt often true. Nevertheless, the tax burdens on others must be raised, eventually if not immediately, to the extent that the burdens of the particular group are lowered. This conclusion rests on simple arithmetic, but if it were appreciated fully there would be many less cases of especially favorable treatment in the tax law.

The apparent tax issue is not necessarily the real one. The total amount of taxes to be raised is an important issue which often conceals more basic issues. Thus, high taxes are often opposed when the real issue is the volume of governmental expenditures. This appears to have been an important factor in the attitude of the Congress towards the recent proposals for more than $10 billion of new taxes. The issue of the volume of taxes may also conceal basic conflicts of interests over such apparently extraneous matters as the desirability of inflationary price rises or other economic effects which might come from higher or lower taxes.

The issue of the proper use of the taxing power also commonly conceals some other issue. An examination of the circumstances under which various groups oppose the use of the taxing power for other than revenue purposes makes one rather suspicious of arguments in this field. Many such opponents are undoubtedly sincere and not motivated by narrow self-interest. Too frequently, however, the real objection to the use of the taxing power for some social or economic purpose is that such use would be contrary to the objector's self-interest. The conflict of interest over the social or economic result of tax policy is concealed under the guise of an objection on grounds of principle, the principle being that the taxing power should not be used for any purpose other than revenue. When the shoe is on the other foot, however, and the use of the taxing power can be made to bring advantage to their group, little difficulty is found by such persons in supporting the

measure. Highly technical provisions of the tax laws may constitute important issues in this respect, because through such provisions, which may be entirely incomprehensible to the general public, special benefits in form of special low rates or exemptions are frequently extended to special-interest groups.

Tax issues also arise where there is underlying harmony. In this case the problem is a soluble one, at least in theory, depending for solution only on an understanding of the facts and on the application of proper tax engineering techniques. It is soluble because there is a one best answer to the problem. In case a tax issue is based on conflict, however, the issue is essentially insoluble. There is no one demonstrably best answer, because a good answer to one person may be a very bad answer to another.

The Political Function and the Public Interest

Still, there must be an answer. It is this necessity for an answer that makes political action, that is, policymaking, a vital function. The function of the policymakers is to decide among the conflicting interests with respect to any particular tax issue.

The test of good tax policy is whether it is in the public interest. What is in the public interest is good, what is against the public interest is bad. Where the interests of all of the people are in harmony, the public interest is easy to determine since it is the common interest of all. Where there are conflicts of interest, however, the public interest is not so easy to determine. Yet the public interest must somehow be located in the maze of conflicting private interests. Where there is a clear majority of people on one side or the other, the public interest will ordinarily correspond with the interests of the majority. But commonly there is no clear-cut majority one way or the other. There is usually a relatively neutral or indifferent group which decides the issue and with respect to the issue represents the public. The part played by the effective public group is to evaluate the claim of each directly interested group and to decide the issue in the manner that will best serve the interests of the members of the effective public group or what they conceive the public interest to be. Since this group is relatively neutral, it is in position to decide the issue fairly and with considerable objectivity. Each directly interested group endeavors to persuade the neutral public group. The decision may be in favor of one of the directly interested groups or it may be a compromise between their demands. As the result of the action of the public group, an equilibrium is reached which will last until changing circumstances or changing opinions again raise the same or a related issue.

This choosing and compromising is the main function of the politician in the best sense of the word. It is not a function which can be performed by tax experts or tax engineers. It represents at bottom a determination of what is in the public interest. Only the public is in position authoritatively to state its interest. The people are often sadly in error as to what are their interests, but obviously no one person can be sure he knows what is the public interest.

It will be readily agreed, no doubt, that the private-interest groups are

not likely to be very much interested in tax principles. They are interested in getting what they want; the principles they espouse are likely to fit their interests as they see them. The neutral public group, however, is open to persuasion on the basis of principles. The interested groups often seriously abuse tax principles in urging upon the neutral public group that their interests are in harmony with principles accepted by the public group. Many crimes of tax propaganda are committed, for example, in the name of the principle of ability to pay.

Toward "Reasonable" Taxation

Because of conflicts of interest and the part they play in tax issues, we cannot hope for ideal taxation. Even if there is such a thing as ideal taxation in contemplation, no one is in position to demonstrate what an ideal system is and the conflicting groups in the community certainly would not recognize it as such. What we can hope for is "reasonable taxation."[1] Reasonable taxation is taxation which constitutes at any given time the nearest practicable approach to the public interest. Reasonable taxes cannot be made fixed and unchanging; they will not stay reasonable with the passage of time and changing conditions. People who lose today in their attempt to get tax changes which would promote their interests will reopen the matter another day when the circumstances seem more favorable. Perhaps on that occasion their private interests will be judged to coincide with public interest and the desired tax change will be made.

This importance of tax conflicts and the prospect of an ever-changing tax system are very distressing to many people, which is not surprising. Conflicts are confusing and leave one without a nice solution. Conflicts tend to take the form of log-rolling for special privileges and loopholes, with a consequent erosion of the tax base and degeneration of the tax system. A long catalogue of failings in the tax system can be laid at the door of conflicting interests. The political process has frequently been distorted to serve narrow special interests which by no stretch of the imagination could be considered the public interest.

One reaction to the problem is to minimize and ignore conflict. This, by and large, is the approach of treatises and textbooks on economics and public finance. Perhaps it is thought that conflict is like sin, something to be kept down by keeping the mind on the higher harmonies. More seriously, a tax system based on high principles reflecting common interests and harmony is both intellectually and emotionally more satisfying than one based on conflict. Tax theory based on harmony can be much more nearly "scientific." Moreover, it is through unity that society is strengthened and through conflict that it is disrupted, sometimes to the point where totalitarianism seems the only solution.

But there is no use in glossing over the facts. Conflict will not go away simply by being ignored; the only result of ignoring it is that the evils growing out of conflict will continue to flourish, the tax system will continue to condemn and the politicians

[1] Cf. John R. Commons, *Institutional Economics* (New York: The Macmillan Company, 1934), pp. 805–840, particularly pp. 820–821, which presents an excellent analysis of the thesis of the present writer.

will continue to be castigated. The conflict is there anyway and in many cases private self-interest is going to decide tax issues. Is it not much the better course to recognize the conflict and bring it into the open? Then one can see better whether the public interest is really being achieved from conflicting private interests. After all if each person evaluates his own competing interests intelligently, if each group really knows its own best interest, if the effective public group understands the relations between group interests and the public interest, and if the political machinery fairly and effectively represents the different interests, the result should be the achievement of public interest in all cases. This is an imposing list of "ifs." They no doubt come true in "never-never land." They are far from being true in the United States today. The point is that the future improvement of tax policy and the tax system rests largely on making them increasingly true.

Unfortunately, there is no secret formula for improving the tax system; there is nothing new on which to pin hope. The old standbys are about all there are, namely, increased understanding, wider dissemination of knowledge, and the improvement of the political machinery. So far as the last of these is concerned, the deficiencies of the system of representative government in the United States have been pointed out many times. While there are no doubt special lines of revision which might be mentioned with particular respect to taxes, time does not permit the discussion of those possibilities in this paper.

It is suggested that more use should be made of an old principle of taxation that has been somewhat neglected. This is the social utility principle of taxation. Tax justice looks to the past and endeavors to levy tax burdens in accordance with the ability of people to pay such taxes as measured by past evidence. Policymakers in the tax field, however, are usually more concerned about the effects taxes will have on employment, production, and the condition of the economy generally than they are on ability to pay, although the latter is not disregarded. They are, at their best, interested in levying taxes in such a way as to contribute to the greatest economic well-being in the future. The generalizing of this point of view into a principle of taxation would mean that taxes would be kept relatively low at those points where taxes interfere with production, and made relatively high at those points where such taxation would not interfere with production. Putting it another way, taxes would insofar as possible be made to fall on social surpluses instead of on social costs. The development of such a principle to the point where specific application could be made to the different tax issues as they arise for settlement would be an invaluable tool for the policymaker. The further development of such a principle depends in part on a much greater knowledge of the effects of taxes than exists today, although inevitably knowledge has outrun practice in some respects.

* * * *

There may be other better ways of achieving greater knowledge of the effects of taxation and greater dissemination of this knowledge. Certainly some changes are needed in American tax policy formation. At the risk of repetition it is to be em-

phasized that the most disquieting aspect of taxation is the dominating role of conflicting interests based too often on shortsightedness and ignorance. The tax system shows signs of degenerating into a collection of myriad provisions conferring special privileges on numerous minority interests. Conflict is inevitable and should be accepted as a necessary and desirable part of the process of arriving at a tax policy which will be in the public interest, but when conflicts disrupt the social and economic structure, society is likely to create artificial uniting forces and institutions and these may be very dangerous to a democratic way of life.

The problem is to find ways to use tax conflicts to produce a finer tax system, one more attuned to the ever-developing needs and ever-changing emphases of the social structure.

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ABRAHAM EPSTEIN

I Cannot Complain About Taxes

RESISTANCE to taxation is all but universal. However, there is also a feeling that taxes provide an opportunity to participate in praiseworthy public undertakings and that they represent a first-rate bargain for the taxpayers. Our book closes upon this note as expressed in the final selection.* (Of course, the tax situation has changed substantially since the middle thirties, when this was written, but the sentiment expressed will always be timely.)

I am a taxpayer. In another week I shall be paying taxes once more. I have just gone over last year's accounts, and totaled up my federal income tax, state income tax and city tax. I should be full of rage. I am expected to protest to my favorite newspaper and sign my letter "an overburdened taxpayer." I have been urged to write to my state assemblyman, my state senator, my Governor, my congressman, my United States Senator and the President of the United States that increased direct taxation is ruining me. I am advised to inform them that higher tariffs and sales taxes are just and proper, but that unless direct taxes are reduced, I shall be forced to move to a state where taxes are

* Reprinted by permission from *The New Republic,* Mar. 15, 1933.

lighter or move out of the United States altogether. I have even been urged to go to Albany and Washington to protest against taxing the good people like myself for the benefit of those who are not so good!

In spite of this I remain cold. My blood pressure remains normal. I am unconvinced despite the knowledge that my governmental representatives, from my alderman to the President of the United States, are constantly thinking of me and are spending sleepless nights seeking ways and means of lightening my tax burden.

I remain skeptical because I *am* a taxpayer. The taxpayers' complaints affected me more profoundly when I could not afford to pay direct taxes. I look at the stub of my checkbook. I sent the government of the United States a little over $24 last year as my family's share of the income tax.[1] I was fairly conscientious about it too. I claimed deductions only on those items which are definitely exempted by the law. I calculate. My wife and I paid in income taxes less than fifty cents a week, less than seven cents a day, toward the maintenance of the federal government.

Seven cents a day! The tip to my waiter at luncheon averages more than that and gives me less satisfaction. I hardly dare criticize his service. But for less than my waiter's tip I am, as a sovereign and almighty taxpayer, privileged to complain bitterly to the President of the United States, the members of his Cabinet and my United States Senator and Congressman. The Secretary of State signs his letters to me "Your Obedient Servant." Every Cabinet officer and congressman is at my beck and call. I can get them to do errands for me which I would not risk asking of my waiter. Unsolicited, my congressman sends me his brilliant speeches and would gladly add The Congressional Record to my daily mail. My wife has just received an excellent booklet from the Children's Bureau about the care of our baby. I constantly get valuable reports from the Departments of Labor and Commerce and the Census Bureau. A monthly review summarizing the most important social and economic data comes regularly from the Bureau of Labor Statistics. Were I forced to obtain this information from private research organizations, the cost would prove prohibitive. Had I owned a farm anywhere in the United States the government would have sent down a whole host of hog experts, corn-borer specialists, Mediterranean-fly scientists and Japanese-beetle wizards for my protection.

But the returns on my seven cents a day do not stop here. When our baby was born abroad, the United States consulate in Paris promptly and courteously attended to all necessary papers. Had I been arrested abroad any American consulate would have given me the fullest protection. Moreover, my seven cents a day help to support hundreds of thousands of war pensioners and disabled veterans. They are helping to feed and clothe a swollen army and navy which my congressmen foolishly believe are necessary for my protection. They are helping to maintain in glory and comfort, I hope, an illustrious body of ancient lawyers on the Supreme Court. My seven cents have helped to buy wheat

[1] I have just received the blank form for reporting this year's federal income tax. On the basis of the same income my new tax would be $104, or twenty-eight and a half cents per day.

from the farmer at three times the price he would have otherwise received. They are helping to keep rivers and harbors navigable and so make for contented congressmen and electors.

Part of my seven cents is still devoted to keeping the land just moist instead of Wet. Though I do not entirely approve of this work, I cannot wax angry about it. I charge up my share to the relief of unemployment through keeping an army of prohibition agents on full pay. I am convinced I would not have been utterly crushed if I had contributed another penny or two a day for the feeding of the unemployed and the hungry.

The state of New York doubled the rate of my income tax last year. My neighbors say the Governor is ruining us good people for the sake of the ne'er-do-wells. They say we already pay the highest income tax of any state in the Union. Mr. Merwin K. Hart of the Associated Industries of New York has threatened to move out of the state because of it. Not that I would miss him! I try to become indignant and I look at my checkbook again. Eighteen dollars! That was the direct contribution of my family toward the maintenance of the state government. I calculate. About five cents a day; one-fourth of what I spend daily on cigarettes; one-half of my daily tips for lunch; one subway fare or the price of my daily newspapers.

I ponder. For five cents the subway guard manhandles and insults me; my waiter hardly speaks to me; and were I to offer that to my barber I could never enter his shop again. But for the same five cents I am a sovereign taxpayer with all rights and privileges! I am the terror of my Governor and my state legislators. Nothing worries them so much as my welfare and my burdens.

For this petty sum I can drive through fields, forests, parks and mountains, over thousands of miles of beautifully kept highways. My five cents helps to keep factories clean and healthy, prevent child labor, supervise a fair workmen's compensation system and enforce the laws against overworking women. My family's health is protected from epidemics. The state helps to supply me and my children with free schools and colleges. Should I go insane the state would place me in a well kept institution and do everything possible to cure my illness. Should I sin and be sent to jail, it would house and feed me as long as I stayed. If I become destitute in old age the state will pay half of a pension to support me until I die. Am I overpaying? Am I overburdened? No other investment brings me such good returns!

But I must have a grievance! I must work up some bitterness over my city taxes. I am told that I live in the most wasteful and corrupt city in America—New York. My mayor is the highest paid city executive in the country. My city's budget is the largest of any city in the world. From what I am told I assume that in no other city is the taxpayer so overburdened. My city's income, moreover, is derived almost entirely from direct taxes. And it is in this city, on what was until two years ago the treasured island of Manhattan, that two mortgage companies and I own a property, *i.e.,* the mortgage companies own it and I collect interest for them in rent from my tenants. My house is assessed at its full value, and my tax bill was $720. "Ruinous taxes," cries my neighbor

who owns a similar house. "We should do something about it. Taxes must be reduced or they will crush us," my fellow taxpayers shout in chorus.

I wonder. There are three families living in my house. The share for each of us was $240 per year, about sixty-five cents a day, or less than five dollars per week. Enormous? Crushing? Terrible?

I start calculating again. Suppose I had to purchase from private corporations everything now supplied me by the city? Would I have been better off? I look over my bills. My electric bill last year amounted to over $100; gas was about $50; and our telephone amounted to another $50 a year. These three items alone cost me nearly as much as all the multitudinous services supplied by the city.

Think of what the city gives me for $4.61 a week! It maintains, keeps fairly clean and well lighted my own street as well as the neighboring streets. It supplies our house with a flawless system of sewerage. For a very small additional charge we receive the finest and most plentiful supply of fresh water at all hours of the day and night. Our garbage and ashes are collected noisily and argumentatively, but regularly. Every so often I see a policeman on my block, presumably for the protection of myself and family. The policeman may have other interests than my protection, but lurking crooks do not know it.

Just a block from our house is a fully manned fire station with the most up-to-date apparatus. For my convenience, the city has built beautiful bridges across wide rivers, a marvelous tunnel and an elaborate system of underground tracks on which fast trains speed me to my destination for five cents a throw. If I and my tenants had each ten children, my city would gladly educate them all, through as competent a staff of teachers as there is in the country, through kindergarten, public school, high school and even university without additional expense. It would also supply them with free books.

My city's service does not stop here. It costs me nearly $150 a year to obtain some protection for my wife and child in case of my death. For this sum I can provide them with only two or three years' protection on our present standard of living. Should I be forced to stop payment this protection would be almost completely lost. But the city stands ready to support my wife and child until he is sixteen years of age, should they be in need after my death. It will not maintain them at our present standard of living, but it will keep them together and provide them with wholesome and sufficient food and shelter.

Should any one of my family fall sick and be unable to pay for medical service, the city will give us free medical care in the best equipped hospitals for as long as we need it. Maybe some of the nurses will not be too polite with us, but we will have a bed and the best medical experts that can be had. Finally, the city will pay half of my old-age pension until the end of my days. It will duly bury me if no one should lay prior claim to my mortal remains.

And as I contemplate, this thought occurs to me: As a taxpayer I am expected to join the Taxpayers' Association and vociferously demand that "taxes be reduced." I am told that only thus can I keep above water in

these days of depression. But my total bill for all direct taxes, including city, state and federal, is less than $300 per year. On the other hand, the interest on my mortgages amounts to over five times as much! I know my neighbors are in the same situation. I wonder why it does not occur to us to demand that "interest rates should be reduced." They really *are* crushing us. Why not reduce electric bills? Why did we permit an increase in telephone rates? Why pay an additional rental of three dollars a year for a telephone instrument whose extra cost of manufacture is not much more? My taxes constitute but a small proportion of my expenses. Why not reduce the more important items? A 10-percent cut in interest would mean an annual saving of over $150 to me. A similar reduction in my taxes means less than $30. My neighbors merely shrug their shoulders and think me queer. "A taxpayer who will not complain about crushing taxes!"

Some of my neighbors, however, give me an argument. "You are fortunate," they say. "You are holding on to your job. Your house is rented. You can afford to pay the taxes without being hurt. But our jobs are gone. Our tenants are not paying rent. We simply cannot bear the burden of taxation. Taxes must be reduced."

And I ask: "Since when have you begun to hold the city responsible for your being out of a job? Is the Honorable John P. O'Brien to blame for the fact that your tenants have no jobs and cannot pay their rent? Is the Governor of the state responsible for these conditions? Do you really blame the federal government? Are you convinced that the governmental agencies are more responsible for your troubles than your mortgagees, your grocer and butcher, who also insist upon their bills being paid? Why then did you telegraph your state legislator and congressman that as a taxpayer you were absolutely opposed to the government extending its protecting arm over jobs and unemployment by a system of state insurance? Did you not vote for Hoover in 1928 because he promised to keep the government from meddling in your and your tenants' economic and financial affairs?"

My neighbors continue to shrug their shoulders. They are convinced I am crazy. As for myself, I am glad that my daily five cents helps my state to maintain a fine system of asylums which, when the proper time comes, will provide decent care for my fellow taxpayers!